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IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

HANOVER INSURANCE COMPANY, SUCCESSOR IN INTEREST TO: MASSACHUSETTS BONDING AND INSURANCE COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

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COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

Paul A. Teschner, Esq., on behalf of Hanover Insurance Company, Successor In Interest To Massachusetts Bonding And Insurance Company, a New York Corporation, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the First Circuit in this case.

OPINIONS BELOW

The opinion of the United States Court of Appeals [App. A, pp. A1-A18] has been reported at ..... F. 2d .....; unofficially it appears at 79-1 U. S. T. C. ¶ 9366 and 43 A. F. T. R. 2d

79-1165. The final opinion of the United States Tax Court [App. C, pp. A20-A40] has been reported at 69 T. C. 260. An earlier decision of the Tax Court [App. E, pp. A42-A52] has been reported at 65 T. C. 715.

JURISDICTION

The opinion of the Court of Appeals was filed on May 8, 1979 at which time the final Judgment of that court was also filed [App. B, p. A19]. The jurisdiction of this Court is invoked under 28 U. S. C. 1254(1).

QUESTIONS PRESENTED

(1) Whether Petitioner properly computed the unpaid losses outstanding component of its underwriting income—as shown on the Annual Statements ["Annual Statements"] Petitioner filed with the National Association (formerly National Convention) of Insurance Commissioners ["NAIC"]—by using the "case method" of computing said unpaid losses outstanding; or whether, rather, Respondent properly reduced those unpaid losses outstanding because in prior years Petitioner had reserved amounts to pay its unpaid losses which hindsight subsequently proved to be more than necessary to pay off the claims for which those prior year reserves had been established.

(2) Whether Respondent properly reduced the unpaid losses outstanding which Petitioner had calculated by the "case method," and used in computing the underwriting income shown on its Annual Statements approved by the NAIC, even though Respondent failed to follow his own Reg. Sec. 1.832-1(b) in that he did not base his adjustments upon the facts of each case.

(3) Whether Respondent had authority to promulgate Reg. Sec. 1.832-1(b) providing that a casualty insurance company must establish to the satisfaction of the District Director that unpaid losses at the close of the taxable year must represent a

fair and reasonable estimate of the amount the company will be required to pay; and whether, if Congress did give Respondent authority to promulgate that regulation, that delegation of legislative power was invalid as being violative of the Fifth Amendment's Due Process Clause in that the delegation was unaccompanied by standards to determine and control its exercise.

CONSTITUTIONAL PROVISIONS, STATUTES, AND REGULATIONS INVOLVED

Constitution of the United States:

> Amendment V. "No person shall * * * be deprived of life, liberty, or property, without due process of law * * *."

Internal Revenue Code of 1954 (26 U. S. C.):

§ 831. Tax on insurance companies (other than life or mutual), mutual marine insurance companies, and certain mutual fire or flood insurance companies.

(a) Imposition of tax.—Taxes computed as provided in section 11 shall be imposed for each taxable year on the taxable income of—

(1) every insurance company (other than a life or mutual insurance company),

* * *

§ 832. Insurance company taxable income

(a) Definition of taxable income.—In the case of an insurance company subject to the tax imposed by section 831, the term "taxable income" means the gross income as defined in subsection (b)(1) less the deductions allowed by subsection (c).

(b) Definitions.—In the case of an insurance company subject to the tax imposed by section 831—

(1) Gross income.—The term "gross income" means the sum of

(A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners.

* * *

(3) Underwriting income.—The term "underwriting income" means the premiums earned on insurance contracts earned during the taxable year less losses incurred and expenses incurred.

* * *

(5) Losses incurred.—The term "losses incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:

(A) To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year.

(B) To the result so obtained, add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year.

* * *

§ 7805. Rules and regulations.

(a) Authorization.—* * * [T]he Secretary or his delegate shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations

as may be necessary by reason of an alteration of law in relation to internal revenue.

* * *

Treasury Regulations on Income Taxes (26 C. F. R.):

Reg. § 1.832-1 Gross Income

(a) Gross income as defined in section 832(b)(1) means the gross amount of income earned during the taxable year from interest, dividends, rents, and premium income computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners. *** The underwriting and investment exhibit is presumed to reflect the true net income of the company and insofar as it is not inconsistent with the provisions of the Code will be recognized and used as a basis for that purpose. ***

(b) Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for "losses incurred" which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and the company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of such losses which, in the opinion of the district director are in excess of the actual liability determined as provided in the preceding sentence will be disallowed as a deduction. The district director may require any such insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for "losses incurred."

Reg. § 1.446-1 General Rules For Methods of Accounting

(a) General rule. (1) * * * The term "method of accounting" includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item.

* * *

(e) Requirement respecting the adoption or change of accounting method.

* * *

(2)

* * *

(ii)(a) A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. * * *

STATEMENT

Massachusetts Bonding and Insurance Company [Petitioner] was organized and commenced doing business in 1907 as a Massachusetts stock insurance company. It was merged into Hanover Insurance Company ["Hanover"] on June 30, 1961. At all times relevant to this case, Petitioner was authorized to write all lines of insurance except title, life, endowment, and annuities; and at all such times Petitioner has engaged in the casualty insurance business by writing such lines of business as fire, accident and health, Workmen's Compensation, liability, automobile liability, automobile physical damage and property damage, fidelity, surety, burglary and theft, and nuclear physical damage. (R. 35-37).[1]

In accordance with the requirements of Massachusetts law, Petitioner filed Annual Statements for the calendar years 1959 (R. 414-463) and 1960 (R. 464-514), and for the six-month

1. "R." references are to the Appendix filed in the Court of Appeals.

period ended June 30, 1961 (R. 515-563), on the form approved by the National Association (formerly National Convention) of Insurance Commissioners ["NAIC"] (App. C, p. A22).

In computing its net income for the calendar years 1959 and 1960 and the period ended June 30, 1961, Petitioner deducted as "losses incurred" the respective amounts of $19,264,486, $21,067,480, and $8,925,671. Those losses incurred were determined by adding to "Losses Paid—Current Year" the amount of "Unpaid Losses Outstanding—Current Year" and deducting therefrom the amount of "Unpaid Losses Outstanding—Prior Year." (App. C, p. A22).

From 18% to 28% of the reserves established by Petitioner to pay for its unpaid losses outstanding were on account of IBNR ["Incurred But Not Reported"] claims; from 9% to 11% of the reserves were on account of Petitioner's share of business done through "pools"; and about 2% of those reserves were on account of "Notice Claims" which were claims up to $500 for auto property damage (App. C, pp. A24-A25). From 59% to 71% of the reserve was established by use of the individual case method ["case method"].

Under the case method of reserving for unpaid losses outstanding, a dollar value was established for estimated liability with respect to each case (App. C, p. A23). Factors considered in reserving for each individual case included the following: (1) the facts of each individual occurrence; (2) the nature of the injuries; (3) the venue of the trial; (4) the identity of the plaintiff's lawyer; (5) the trend and development of the law; (6) the trend of inflation; (7) the variance in state laws; (8) the age and condition of a claimant; (9) the peculiar characteristics—such as occupation, family relationships, and personality—of an injured party; (10) the increasing litigious nature of the public; and (11) the increasing ability and sophistication of plaintiff's personal injury lawyers as a class. [R. 103-111; App. C, p. A23).

Petitioner's IBNR reserves—like its case method reserves—were established only after consideration was given to a multitude of current facts; upon that point, Petitioner's Treasurer testified as follows (R. 198-200):

> "Q. Is there any reasonable alternative to the use of formula reserves for I.B.N.R. claims?
>
> "A. No, there is no reasonable alternative at all.
>
> "Q. Once a formula is developed to compute your I.B.N.R. reserve, may it validly continue to be used without change in the future?
>
> "A. That's impossible, no, it can't.
>
> "Q. Well, how often would you have to review these?
>
> "A. Well, to begin with, we're talking about a formula reserve. This formula reserve is based on past experience. As I said I believe, it's a preliminary I.B.N.R. reserve. You don't take a formula reserve in and accept it and throw it in your annual statement and say—that's an I.B.N.R. reserve willy-nilly. That's useless—it's meaningless. It doesn't mean a thing. We—that's only the beginning. We establish this formula reserve and then we consider many other elements. In the first place we talk about premiums in force which is a measure of the amount of business you have in force—the contracts you have in force. Well, you just can't accept that in force figure at its face value. You go back and see what occurred during the year that might have affected that in force figure compared to the year before. For example, you could have some changes in rates—in premium rates on policies which could have gone up with the result your in force would be inflated without a corresponding increase in exposure and liability. You take that into consideration and make appropriate adjustments that are called for. You take a look at the most recent development of I.B.N.R. You take a look at your claim frequency. You take a look at your average cost per claims and say to yourself—how are these going to affect this I.B.N.R. formula reserve you come up with. Do you have to adjust it or don't you? Is inflation a factor in here? Or is—how about your reinsurance treaties? Are you retaining a greater portion of the loss than you did before? How is that going to affect your I.B.N.R.? There are many elements that affect it."

Petitioner's pool reserves were not evaluated by Petitioner; Petitioner's pro-rata share of those reserves for unpaid losses was accepted as determined by the pools. The reason for that acceptance was expressed as follows by the NAIC examiners (R. 782):

> "Underwriting associations in which the Company participated were not examined. Under a plan adopted by the National Association of Insurance Commissioners in 1946, separate examinations of associations, pools and syndicates are required to be made under the supervision of the respective states wherein these associations maintain their principal offices. Financial statements furnished by associations were accepted in support of the Company's proportionate equities in associations. Additional information deemed necessary was obtained through correspondence."

The fourth category of Petitioner's reserves for unpaid losses outstanding was for the Notice Claims which were described as follows by one of Petitioner's witnesses (R. 240):

> "We had a * * * system of on our claim reporting, rather than prepare a complete claim file on every claim that came in—on auto property damage and auto physical damage claims up to $500 were very easily and quickly disposed of or settled rather. So rather than set up a voluminous claim file with all the necessary typing and multiplicity of copies that were necessary, they were reserved on a formula basis. * * * These were set—they were a formula reserve. We called them notice. * * *"

Under Petitioner's case method of reserving for unpaid losses outstanding, which it used whenever possible (App. C, p. A31), no reserve of $1,000 or more could be set up for any individual case without the specific approval of Petitioner's Vice President-Claims (R. 110). That method also required that the employees of Petitioner constantly be aware of the serious consequences of "under reserving" (R. 116-118, 200, 217, 254) and be equally alert to guard against the dangerous consequences of "over reserving" (R. 102, 200, 216, 252-255).

Under its case method of reserving, Petitioner at all times did its best to avoid both over reserving and under reserving; it had no basic philosophy to err, if necessary, either on the side of over reserving or under reserving; and at all times it attempted to establish adequate, proper, and reasonable reserves which would be sufficient to pay off claims (R. 118, 200-201, 217, 255-256).

Every three years the books and affairs of casualty insurance companies are examined by participating representatives of the NAIC; Petitioner had its books and affairs examined by the NAIC representatives as of the ends of 1950, 1953, 1956, and 1959 (R. 158-159). When they conducted an examination of Petitioner, the NAIC examiners received all of Petitioner's records required for a complete audit, including the working papers supporting the Annual Statements and a listing of all individual claim files (R. 208-209).

The listing of individual claim files which Petitioner supplied to the NAIC examiners included a case-by-case listing of all claims open as of the year end of the examination and a history of those claims between the year end and the time of the examination (R. 211). During the course of each examination, Petitioner supplied the NAIC examiners with thousands of individual claim files which the examiners would then review over a period of six to eight months (R. 129-130).

In examining the individual claim files of Petitioner as of a given year end, the NAIC examiners took into consideration the history of all claims between the close of the year and the time of the examination (R. 135, 759). When examining individual claim files which were still open at the time of the examination, the NAIC examiners would discuss with Petitioner's Claims Vice President whether a particular loss reserve was proper; and that inquiry would be concerned with whether the reserve was too high as well as too low (R. 131).

The NAIC examiners who examined the period of December 31, 1959, through December 31, 1963, of Petitioner and of

Hanover severely criticized its formula handling of its small (notice) claims and increased the reserve for unpaid losses outstanding with respect to such formula small claims by $630,874.35 (R. 869-870, 906).

When Petitioner filed its federal income tax returns for 1959, 1960, and for the six months period ended June 30, 1961, it filed with and as part of those returns the respective Annual Statements approved by the NAIC for those years and for that period (R. 212-213). Petitioner computed its taxable income for those years and for that period on the basis of the net income shown at line 20 of the underwriting and investment exhibits of those Annual Statements (App. C, p. A22).

In due course, the Commissioner of Internal Revenue ["Respondent"] audited Petitioner's federal income tax returns for 1959, 1960, and the six months period ended June 30, 1961. In reviewing Petitioner's reserves for its unpaid losses outstanding, Respondent did not examine any of Petitioner's individual claim files (R. 133). In reducing Petitioner's said reserves, Respondent did not base his adjustments on the facts of each claim and Petitioner's experience with similar claims, nor did Respondent make a comparison of Petitioner's unpaid losses outstanding at the end of any period here involved with subsequent payments of such losses. Respondent relied exclusively upon amounts of reserves for unpaid losses outstanding appearing on Petitioner's Annual Statements for prior years and then developed *those* amounts into future years to arrive at its current year reductions of Petitioner's unpaid losses outstanding. (App. A, pp. A5-A8; App. C, pp. A25-A27; R. 62-70). Respondent's methodology was based on a conclusive presumption "that the reserve redundancy or deficiency [for prior years] remains a consistent percentage of the reserve carried [for the current year]." (R. 930).

The deficiencies at issue in this case are attributable, in their entirety, to Respondent's reductions of the unpaid losses outstanding used by Petitioner in computing its underwriting in-

come reflected by the underwriting and investment exhibits of Petitioner's Annual Statements. Petitioner filed a Petition For Redetermination of those deficiencies with the United States Tax Court.

Hanover Insurance Company v. *Commissioner of Internal Revenue*, 65 T. C. 715 (1976), (App. E, pp. A42-A52), denied Petitioner's Motion For Summary Judgment. The final opinion of the Tax Court is reported at *Hanover Insurance Company* v. *Commissioner of Internal Revenue*, 69 T. C. 260 (1977), (App. C, pp. A20-A40). The opinion of the United States Court of Appeals for the First Circuit, affirming that portion of the opinion of the Tax Court which held against Petitioner, appears at *Hanover Insurance Company* v. *Commissioner of Internal Revenue*, ... F. 2d ..... (1st Cir. 1979), (App. A, pp. A1-A18). The opinion of the Court of Appeals has been unofficially reported at 79-1 U. S. T. C. ¶ 9366 (C. C. H.) and 43 A. F. T. R. 2d 79-1165 (P. H.).

REASONS FOR GRANTING THE WRIT

(1) The decisions of the courts below have upheld Respondent's reductions of Petitioner's unpaid losses outstanding even though those reductions constituted a change in Petitioner's method of accounting for its unpaid losses outstanding, an accounting method specifically required, approved, and followed by the National Association (formerly National Convention) of Insurance Commissioners ["NAIC"]. For that reason, those decisions are in conflict with this Court's applicable decisions in *United States* v. *Consumer Life Insurance Co.*, 430 U. S. 725, 739, 749-750, and *Commissioner of Internal Revenue* v. *Standard Life & Accident Insurance Co.*, 433 U. S. 148, 161-162, 163.

Under Section 832(b)(5)(B) of the Internal Revenue Code of 1954 ["Code"], a casualty insurance company's "unpaid losses outstanding" constitute a major item in the computation of the

"losses incurred" component of "underwriting income" as defined at Section 832(b)(3) of the Code. Respondent's own regulations, therefore, affirm the conclusion that any change in the method of computing a casualty insurance company's unpaid losses outstanding is a change in a method of accounting. *Reg. § 1.446-1(a)(1):* "The term 'method of accounting' includes * * * the accounting treatment of any item." *Reg. § 1.446-1(e)(2)(ii)(a):* "A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan."

Bituminous Casualty Corporation v. *Commissioner*, 57 T. C. 58 (1971), held that the casualty insurance company correctly included in its unearned premiums its reserves for premium rebates (retrospective rate credits and premium discounts). The Court recognized the fact that by their very nature insurance companies are not subject to ordinary tax accounting concepts [57 T. C. 58 at 76, 77]:

> "* * * [T]he insurer cannot know what the losses will be at the time the reserve must be estimated, even with respect to expired policies. In the case of retro policies, it may be as long as eight or nine years before all of the facts which determine liability will have occurred."
>
> "The nature of casualty insurance requires accounting rules substantially different from the accounting rules applicable to general commerce.
>
> "In commerce generally, expenses come first and income follows. The manufacturer must incur the cost of manufacturing his product before he gets paid for it. The merchant must purchase his inventory before he can resell it.
>
> "In the insurance industry, however, the reverse is true. The policyholder pays the insurance company in advance and the insurance company's costs, which are primarily the payment of claims, come afterward. If the premiums were to be taxed as received and the deductions allowed only as they later became fixed, the result would be to tax very large sums of money as income when in fact

those amounts will never really become income because they will have to be paid out to policyholders and other claimants."

In *United States* v. *Consumer Life Insurance Company*, 430 U. S. 725, this Court rejected the Government's argument that unearned life premium reserves should be attributed to the taxpayer because it had performed the services with respect to which the reserves were established. The Court rejected the Government's attempt to rely upon garden variety accounting concepts [430 U. S. 725 at 739]:

> "18. The Government also relies on an asserted analogy to *Commissioner* v. *Hansen*, 360 U. S. 446 (1959). That case, dealing with a question of ordinary accrual accounting, is inapposite. Life insurance accounting is a world unto itself. See *Brown* v. *Helvering*, 291 U. S. 193, 201 (1934); *Great Commonwealth Life Ins. Co.*, 491 F. 2d 109 (CA 5 1974). Mechanical application of ordinary accounting principles will not necessarily yield a sound result."

The Court also recognized the special nature of the regulated insurance industry [430 U. S. 725 at 749-750]:

> "Section 820 affords an unmistakable indication that § 801 does not impose the 'reserves follow the risk' rule. Instead, Congress intended to rely on customary accounting and actuarial practices, leaving, as § 820 makes evident, broad discretion to the parties to a reinsurance agreement to negotiate their own terms. This does not open the door to widespread abuse. 'Congress was aware of the extensive, continuing supervision of the insurance industry by the states. It is obvious that subjecting the reserves to the scrutiny of the state regulatory agencies is an additional safeguard against overreaching by the companies.' * * *"

This Court affirmed the unique nature of insurance tax accounting and the primacy of NAIC accounting requirements in the case of *Commissioner* v. *Standard Life & Accident Insurance Co.*, 433 U. S. 148. The Court held that NAIC accounting rules properly determined the federal income tax question at issue there [433 U. S. 148 at 161-162, 163]:

> "The fourth approach, in contrast, does have support in the statute. This approach has been adopted by the NAIC for the purpose of preparing the Annual Statement, and therefore is firmly anchored in the text of § 818(a) which establishes a preference for NAIC accounting methods.[24] Under this view, the net valuation portion of the unpaid premiums is included in reserves, assets, and gross premium income, while the loading portion is entirely excluded. This approach might be described as adopting the fictional assumption that the net valuation portion of the premium has been paid, but that the loading portion has not."
>
> * * *
>
> "Accordingly, we conclude that unpaid premiums must be reflected in the computation of respondent's tax liabilities 'in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.' To the extent that the Secretary's regulations require different treatment of unpaid premiums, we hold that they are inconsistent with § 818(a) and therefore invalid."

At Section 832(b)(1)(A) of the Code, Congress specifically has decreed that for a casualty insurance company "* * * [t]he term 'gross income' means the sum of * * * the combined gross amount earned during the taxable year from investment income and from underwriting income as provided in this subsection computed on the basis of the underwriting and investment exhibit of the annual statement ["Annual Statement"] approved by the National Convention [now Association] of Insurance Commissioners." Petitioner, in computing the amount of underwriting income to be included in its Annual Statement, used the case method of computing its unpaid losses outstanding (App.

"24. Evidence of congressional respect of NAIC accounting methods is not limited to the portion of the Code concerning life insurance companies. In defining 'gross income' and 'expenses incurred' for purposes of taxing certain other insurance companies, Congress expressly requires computations to follow 'the annual statement approved by the National Convention of Insurance Commissioners.' 26 U. S. C. §§ 832(b)(1)(A), (b)(6)."

C, pp. A23, A31). The NAIC examiners, in auditing the books and affairs of Petitioner, likewise followed the case method in evaluating Petitioner's unpaid losses outstanding (R. 129-130, 131, 135, 208-209, 211, 759).

When Respondent refused to follow the case method of calculating unpaid losses outstanding, and substituted a method based upon a conclusive presumption that prior year "overstatements" of unpaid losses outstanding (as determined by the use of hindsight) continued unabated into the current tax year, he changed Petitioner's method of accounting for its unpaid losses outstanding and followed a procedure which conflicted absolutely with this Court's *Consumer Life Insurance Co.* and *Standard Life & Accident Insurance Co.* decisions.

(2) By failing to use the case method in reviewing Petitioner's unpaid losses outstanding, Respondent disregarded his own Reg. § 1.832-1(b). That regulation requires that the determination of a taxpayer's unpaid losses be "based upon the facts of each case." Petitioner followed that regulation in computing its income. The extent to which a taxpayer may rely upon one of Respondent's regulations, and the extent to which Respondent may disregard his own regulations in assessing deficiencies, present important questions of federal law which should be settled by this Court.

Although other federal courts have on occasion held that Respondent is bound by his own regulations (See, for example, *Mutual Savings Life Insurance Co.* v. *United States* (5th Cir. 1974) 488 F. 2d 1142, 1145-1146; *Tipton and Kalmbach, Inc.* v. *United States* (10th Cir. 1973) 480 F. 2d 1118, 1121; *Weyerhaeuser Company* v. *United States* (Ct. Cl. 1968) 395 F. 2d 1005, 1008; and *Brafman* v. *United States* (5th Cir. 1967) 384 F. 2d 863, 866), no decision of this Court so holding has been found. It is respectfully suggested that those questions are vital to the proper administration of the revenue laws and should be settled in this case.

A good example of the importance of the question presented is the case of *Continental Insurance Company* v. *United States* (Ct. Cl. 1973) 474 F. 2d 661. The question there was whether Respondent's Reg. § 1.832-1(c), as written, was binding upon him or whether he was entitled to construe it to mean something different from what it seemed to mean. Like Petitioner here, Continental Insurance Company was a stock fire and casualty insurance company. In a unanimous *en banc* decision, the Court of Claims granted Continental's motion for summary judgment.

The question presented in the *Continental Insurance* case was whether the taxpayer could exclude from its "salvage recoverable outstanding" adjustments, allowable under Section 832(b)(5)(A) of the Code, all salvage not yet reduced to cash or its equivalent. The insurance departments of some (but by no means all) states in which the taxpayer did business had rules or regulations prohibiting credit for salvage until reduced to cash or its equivalent.

The Annual Statements filed by Continental Insurance Company included in "salvage recoverable outstanding" only salvage which had been reduced to cash or its equivalent. Those computations were based on the requirements that items reflected in an Annual Statement apply equally to all of an insurance company's business, wherever conducted, and that none of the assets or liabilities, or items of income or deduction, are to be allocated on a state-by-state basis.

The Commissioner assessed federal income tax deficiencies because the amounts of salvage recoverable outstanding shown on the Annual Statements of Continental Insurance company were less than the amounts he considered to be reasonable. By Reg. § 1.832-1(c), Respondent had decreed that the statutory phrase of Section 832(b)(5)(A), "salvage recoverable outstanding," would mean "salvage in course of liquidation * * * except that [salvage] which may not be included by reason of express statutory provisions (or rules and regulations of an insurance department) of any state * * *."

The Commissioner interpreted his own Regulation to mean that a casualty insurance company, in computing its "losses incurred" under Section 832(b)(5) for federal income tax purposes, must take into consideration *all* salvage in course of liquidation except that with respect to which a particular state applied a contrary rule. Some states did indeed have rules and regulations forbidding the use of salvage estimates.

The taxpayer chose to base its case upon a challenge of the Commissioner's interpretation of the Regulation. It argued that even under the Commissioner's own standard a casualty insurance company was not required to reduce losses paid by any "salvage in the course of liquidation" if the rules or regulations of the insurance department of *any* state in which it did business did not permit that salvage to be taken into account.

The United States Court of Claims, in granting the taxpayer's motion for summary judgment, noted the heavy state regulation of the insurance business, then concluded by stressing the fact that there was no good tax reason to support the Commissioner's redetermination of Continental's salvage recoverable outstanding as reported on its Annual Statement [474 F. 2d 661 at 666, 671]:

> "At the outset it must be recognized that the casualty insurance business is a thoroughly regulated industry. The terminology and concepts of the Internal Revenue Code and Regulation provisions dealing with casualty insurance are based directly on industry usage developed in response to state regulation. * * *"
>
> "Finally, we have considered the fact that in the long run it will make no substantial difference in the amount of taxes paid whether salvage recoveries are treated on a "paid" basis or whether estimates are required to be made. Sooner or later salvage recoveries must be taken into income for tax purposes. Thus, there is no question of tax avoidance presented here, but merely a question of when salvage is to be taken into account for purposes of the federal income tax. * * * In these circumstances it seems best not to overthrow long-established practice merely to accelerate the receipt of taxes. Such a course of action would cause needless trouble and expense to insurance companies without the realization of any significant offsetting advantage to the government."

In disagreeing with the *Continental Insurance* case, the Court of Appeals stated (App. A, p. A13, *n 16*):

> "To the extent that the Court of Claims found no 'significant offsetting advantage to the government' in allowing taxpayer's exclusions and resultant reduction of its taxable income, we find *Continental Insurance, supra,* inapplicable to the present case. For example, given the deficiency of $331,664.28 assessed here and an annual interest rate, before compounding, of 7%, the disadvantage in delayed receipt of these funds of one year amounts to $23,215.10—not an insignificant figure."

(3) Section 832(b) provides that a casualty insurance company's gross income, a component of which is its unpaid losses outstanding, shall be computed on the basis of the insurance company's Annual Statement approved by the NAIC. By Reg. § 1.832-1(b), Respondent has attempted to change the statute to provide that the computation of gross income and unpaid losses for federal income tax purposes will be on the basis of Annual Statements unless a district director determines that a casualty insurance company's unpaid losses exceed "a fair and reasonable estimate of the amount the company will be required to pay."

If Congress had intended the Annual Statement to be less than conclusive for federal income tax purposes, it knew how to accomplish that objective. See, for example, *Western National Life Insurance Company of Texas* v. *Commissioner of Internal Revenue,* 432 F. 2d 298 (5th Cir. 1970), where the Court grounded its decision upon the fact that in the statute itself Congress had provided that life insurance company taxes would not always be based exclusively upon Annual Statements [432 F. 2d 298 at 301]:

> "We also agree with the decisions in these two cases to the effect that the Congress did not adopt the N. A. I. C.

> form of statement for its accounting method as to determining its tax base for [life] insurance companies. As will appear from the statute itself, the N. A. I. C. annual statement was referred to as being the proper standard 'except as provided in the preceding sentence,' the preceding sentence providing that all computations should be under an accrual method of accounting. * * *"

Congress did not, of course, place similar limitations upon the computation of federal income tax liabilities of casualty insurance companies; the statute itself makes no exceptions to the rule that tax liability is to be computed on the basis of Annual Statements of such insurers.

The Court of Appeals upheld the validity of the regulations because "[s]tandards for the exercise of this power are found in the substantive provisions of the Code which are enforced by the regulations in question" (App. A, p. A16). This test would have meaning if the regulations had, for example, interpreted the purview of "on the basis of the underwriting and investment exhibit of the annual statement * * *." The regulations did not do that, however, and one searches the substantive provisions of the statute in vain for any touchstone by which the regulations may be grounded to the statute.

Because it is not grounded to the pertinent provisions of the Code, Reg. § 1.832-1(b) is in direct conflict with applicable decisions of this Court which have invalidated regulations by Respondent which have sought to change or add to the statutory provisions. Some of the cases of this Court with which the lower court decisions conflict include: *Dollar Savings Bank* v. *United States*, 19 Wall. (86 U. S.) 227, 236-237; *Swift Company* v. *United States*, 15 Otto (105 U. S.) 691, 694-695; *Iselin* v. *United States*, 270 U. S. 245, 250-251; *Old Colony Railroad Co.* v. *Commissioner*, 284 U. S. 552, 561 ("If there were doubt as to the connotation of the term, and another meaning might be adopted, the fact of its use in a tax statute would incline the scale to the construction most favorable to the taxpayer."); *Miller* v. *Standard Nut Margarine Co.*, 284 U. S. 498, 508;

Koshland v. *Helvering*, 298 U. S. 441, 446-447; *White* v. *Aronson*, 302 U. S. 16, 20; *M. E. Blatt Co.* v. *United States*, 305 U. S. 267, 279; *Helvering* v. *Janney*, 311 U. S. 189, 194-195; *Taft* v. *Helvering*, 311 U. S. 195, 198-199; *Helvering* v. *Credit Alliance Corporation*, 316 U. S. 107, 113; *Helvering* v. *Sabine Transportation Co., Inc.*, 318 U. S. 306, 311-312; *Trust of Bingham* v. *Commissioner*, 325 U. S. 365; *United States* v. *Calamaro*, 354 U. S. 351, 358-359; *Commissioner* v. *Acker*, 361 U. S. 87, 92, 93-94; and *United States* v. *Cartwright*, 411 U. S. 546, 557.

Assuming *arguendo* that Congress intended to vest Respondent with authority to promulgate Reg. § 1.832-1(b)—and there are no words which would indicate such an intent—the next inquiry would be whether such an intent was properly expressed. Because there are no particular delegations of power here, presumably Respondent finds his authority in the general, catchall provisions of Section 7805 of the Code. Section 7805 delegates to Respondent authority to make all "needful rules and regulations" for enforcement of the Internal Revenue Code. The question is whether that delegation—as applied to the facts of this particular case—was accompanied by sufficient standards to meet due process essentials.

Panama Refining Company v. *Ryan*, 293 U. S. 388, held that certain regulations relating to the oil industry which had been prescribed under Section 9(c) of the National Industrial Recovery Act were invalid because Congress had not declared a policy to guide the administrator [293 U. S. at 415, 430]:

> "* * * [The statute] does not seek to lay down rules for the guidance of state legislatures or state officers. * * * [It] does not state whether, or in what circumstances nor under what conditions, the President is to prohibit the transportation of the amount of petroleum or petroleum products produced in excess of the State's permission. It establishes no criterion to govern the president's cause. *** So far as this section is concerned, it gives to the President an unlimited authority to determine the policy and to lay

down the prohibition, or not to lay it down, as he may see fit. * * *"

"Thus, in every case in which the question has been raised, the Court has recognized that there are limits of delegation which there is no constitutional authority to transcend.*** [T]he Congress has declared no policy, has established no standard, has laid down no rule. There is no requirement, no definition of circumstances and conditions, in which the transportation is to be allowed or prohibited."

Mr. Justice Cardozo dissented from the *Panama Refining* case because, he thought, there had been an adequate delegation of standards in that the legislature had defined the subject matter of the delegated power as being the need for controlled transportation in interstate and foreign commerce in petroleum and petroleum products; but later he joined a unanimous Court in the famous "sick chicken" case of *Schechter Poultry Corporation* v. *United States,* 295 U. S. 495. In concurring in that decision, which invalidated the N. R. A. Codes for the governance of trades and business, Mr. Justice Cardozo remarked [295 U. S. at 551]:

"The delegated power of legislation which has found expression in this Code is not canalized within banks that keep it from overflowing. It is unconfined and vagrant. * * *

"* * * Here, in the case before us, is an attempted delegation not confined to any single act nor to any class or group of acts identified or described by reference to a standard. Here in effect is a roving commission to inquire into evils and upon discovery correct them."

While we have long honored Mr. Justice Cardozo for his multiple admirable qualities, up until now clairvoyance has not been recognized as one of them. But does he not summarize precisely what Respondent has done here: having discovered the "evils" of a tax statute which defines gross income by reference to a standard he is unable to control, Respondent would exorcise them by rewriting the statute to meet his own idea of virtue.

Had Congress wished, it easily could have delegated power to Respondent in such a way that it would have been "canalized within banks that keep it from overflowing" so that it would not be "unconfined and vagrant." Some examples from the Code itself would include Section 820 which vests Respondent with particular power to issue regulations with respect to "Optimal Treatment Of Polices Reinsured Under Modified Coinsurance Contracts," Section 171(b)(3)(B) which specifically states that amortization of bond premium is to be "in accordance with regulations prescribing reasonable methods" of amortization; and Section 166(c) which allows, in lieu of a direct deduction for wholly or partially worthless business bad debts, "(in the discretion of the Secretary) a deduction for a reasonable addition to a reserve for bad debts."

Canalization of Respondent's power might also have been accomplished albeit perhaps not so effectively had Congress at least legislated a "reasonable" requirement in Section 832(b) itself. Congress also is familiar with this legislative technique; witness, for example, Section 162(a)(1) which includes as deductible trade or business expenses "a *reasonable* allowance for salaries or other compensation for personal services actually rendered" and Section 167(a) which allows "as a depreciation deduction a *reasonable* allowance for" depreciation [emphasis supplied]. If Congress had done that, then an argument could indeed be made that regulations defining "reasonable" would have been "needful" within the meaning of Section 7805, hence properly canalized within the meaning of the *Panama Refining* and *Schechter* cases.

CONCLUSION.

The Petition For A Writ Of Certiorari should be granted.

Respectfully submitted,

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July 1979

APPENDIX A

OPINION OF THE UNITED STATES COURT OF APPEALS

UNITED STATES COURT OF APPEALS
For the First Circuit

No. 78-1407

HANOVER INSURANCE COMPANY,
Successor in interest to:
MASSACHUSETTS BONDING AND INSURANCE COMPANY,
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

Before

COFFIN, *Chief Judge,*
BOWNES, *Circuit Judge,*
PETTINE, *District Judge.**

Paul A. Teschner for appellant.

Daniel F. Ross, Attorney, Tax Division, Department of Justice, with whom *M. Carr Ferguson,* Assistant Attorney General,

* Of the District of Rhode Island, sitting by designation.

Gilbert E. Andrews and *Richard W. Perkins,* Attorneys, Tax Division, Department of Justice, were on brief for appellee.

May 8, 1979

PETTINE, *District Judge.* Appellant Hanover Insurance Company (Hanover) seeks this Court's review of a decision of the United States Tax Court upholding the Commissioner's determination of a deficiency in the income tax of Massachusetts Bonding and Insurance Company (MBI) for the taxable year 1960. Hanover is the successor in interest to MBI, which was merged into Hanover on June 30, 1961.

MBI filed federal income tax returns for its calendar years 1959 and 1960 and its taxable period ending on June 30, 1961 (the date of its merger into Hanover) with the District Director of the Internal Revenue Service in Boston, Massachusetts. On December 20, 1970 the Commissioner issued a Notice of Deficiency to Hanover in which he determined a deficiency of $441,081.10 for 1959 and $446,206.34 for 1960. On March 30, 1978 the United States Tax Court entered its final decision in this matter, in which it found that there was a deficiency in MBI's 1960 income tax of $331,644.28.[1] It is that determination which is challenged before this Court.

MBI was a casualty insurance company with its principal place of business in Massachusetts.[2] During the years at issue

1. The Tax Court denied Hanover's motion to dismiss on January 7, 1976. *Hanover Insurance Company* v. *Commissioner of Internal Revenue,* 65 T. C. 715; appeal dismissed, No. 1557-71 (May 11, 1976). In accordance with its opinion on the merits, *Hanover Insurance Company* v. *Commissioner of Internal Revenue,* 69 T. C. 260 (1977), the Tax Court held that no deficiency existed in MBI's 1959 tax, but it recomputed the deficiency in MBI's 1960 tax in the final amount of $331,644.28.

Both parties filed timely notice of appeal. The Commissioner has dismissed his appeal, leaving only Hanover's challenge as to the 1960 deficiency pending before this Court.

2. For a more detailed discussion of the facts and financial data involved in this case, the reader is referred to the opinion of the Tax Court on the merits, 69 T. C. at 262-268.

here, it wrote 24 lines of casualty insurance. MBI filed annual statements with the Massachusetts Commissioner of Insurance, utilizing the form of an annual statement approved by the National Association of Insurance Commissioners (N. A. I. C.).[3] That form also was utilized by MBI in its computation of taxable income for federal tax purposes pursuant to the requirements of I. R. C. § 832.

I. R. C. § 832(a) defines "insurance company taxable income" as "the gross income as defined in subsection (b)(1) less the deductions allowed by subsection (c)." Subsection (b)(1)(A) defines "gross income" for this purpose as

> the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the [N. A. I. C.].

"Underwriting income" is defined thereafter as 'the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred." § 832(b)(3). § 832(c) also authorizes the deduction from taxable income of losses incurred.

The present dispute involves the computation of MBI's "losses incurred" under § 832(b)(3). The Code provides for computation of this figure as follows:

> The term "losses incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:
>
> (A) To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year.
>
> (B) To the results so obtained, add all unpaid losses outstanding at the end of the taxable year and deduct un-

3. *See* M. G. L. A. c. 175 § 25.

paid losses outstanding at the end of the preceding taxable year.

I. R. C. § 832(b)(5).

Treas. Reg. § 1.832-1 (1960)[4] repeats the requirements of I. R. C. § 832 and admonishes insurance companies to "be prepared to establish to the satisfaction of the District Director" that

> the part of the deduction for "losses incurred" which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay.

The regulation warns further that amounts in excess of actual liability so determined will be disallowed as deductions, and that the District Directors may require submission of information sufficient to establish "the reasonableness of the deduction for 'losses incurred' ".[5]

Thus the Code recognizes that "unpaid losses outstanding" can only be estimated for a given year when that year's return is filed, because the amount of payments which will be made on all

4. As amended by T. D. 6867, 30 F. R. 15094, (December 12, 1975).

5. The regulation also refers to the N. A. I. C. form:

> The underwriting and investment exhibit [of the N. A. I. C. form] is presumed to reflect the true net income of the company, and insofar as it is not inconsistent with the provisions of the Code will be recognized and used as a basis for that purpose. All items of the exhibit, however, do not reflect an insurance company's income as defined in the Code. . . .

The regulation goes on to require that certain items on the N. A. I. C. form be excluded in the computation of taxable income, and that, in computation of the item entitled "losses incurred", "the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them." § 1.832-1(a).

outstanding claims cannot be ascertained until settlement or litigation of all claims arising during that year. Treas. Reg. § 1.832-1(b) anticipates that insurance companies will deduct only a "fair and reasonable estimate" of actual unpaid losses outstanding. The Commissioner's notice of deficiency for 1959 and 1960 was the result of the parties' differences of opinion as to the proper amount of deduction which should be allowed in the computation of MBI's taxable income for those years.

MBI calculated its unpaid loss reserve—the same figure it claimed as a deduction—according to two methods. One method involved examination of individual cases by claims examiners who estimated the dollar value of liability. A second approach, used to estimate the value of claims which presumably had occurred but were not yet reported, involved application of a formula based on historical experience to premiums in force for a given period.[6]

For the taxable year 1960, the Commissioner's method for testing the reasonableness of an insurance company's unpaid loss deduction was based on a historical analysis of prior years' estimated and actual losses.[7] The Commissioner examined the

6. *See* 69 T. C. 263-264.

7. The Commissioner's testing method applicable to the year 1960 was set forth in Mimeo R. A. No. 1366, issued by the Commissioner of Internal Revenue on July 1, 1944. It provides in relevant part:

> In the determination of unpaid losses . . . consideration should be given to the following requirements:
>
> 1. That the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them. . . .
> 2. That the Bureau is not required to accept the figures shown in the [N. A. I. C.] Annual Statement. . . .
> 3. That particular attention be given, in the investigation of the books and records of the taxpayers, for evidence of "leading" [should be "loading"] in the computation of the deduction for unpaid losses.
> 4. That an adjustment at the close of each year . . . should be made if the information available indicates

(Footnote continued on next page.)

taxpayer's experience in years prior to the taxable year in question to determine whether reserves for losses were greater or less than actual losses for the prior years. The actual, or "developed" losses were ascertained after they were paid out in subsequent years. Although the testing method varied among

(Footnote continued from preceding page.)

> the estimates of unpaid losses for 1944 or subsequent years are excessive. . . .
>
> With respect to Item 4 above, the policy of the Bureau will be as follows:
>
> A. That the total of unpaid losses at the end of any year should be the aggregate of the reasonable estimates of the outstanding losses made approximately as of the close of the year on the basis of the facts in each claim and the taxpayer's experience with similar claims.
>
> B. That in determining whether or not the estimate of unpaid losses is reasonable, a comparison should be made with the past experience of the company and with subsequent payments of such losses, or by any other proper comparison.
>
> C. In the application of B the following method of verifying the reasonableness of unpaid losses of casualty and surety companies on all lines other than Workmen's Compensation and Public Liability is suggested: Information that will disclose the reasonableness of the unpaid loss liability as set up by the taxpayer may be secured from Schedule O of the Annual Statement. A comparison of the amounts still estimated as unpaid at the end of such year, (developed losses) should be made with the previous year's estimate of unpaid losses (estimated losses) to determine the ratio of "estimated losses" to one-year "developed losses". Such comparison should be made separately for each year for the previous five years. If the average "estimated losses" of the previous five years is found to be not more than 115% of the five-year average of the one-year "developed losses", the estimates made will be regarded as being reasonably correct, and no adjustment for the current year would ordinarily be required.
>
> In the event that the five-year average of "estimated losses" is in excess of 115% of the five-year average of the one-year "developed losses" then the unpaid loss liability of the company will be deemed to be excessive in the current year and an adjustment will ordinarily be required. In determining the extent of the

(Footnote continued on next page.)

different categories of insurance,[8] the ultimate rule of thumb was the same for all lines of insurance. If reserves for prior years proved to have exceeded developed losses for those years

(Footnote continued from preceding page.)

> adjustment to be made to the outstanding losses at the end of the year, in accordance with the preceding sentence, due regard should be given to the actual amount paid thereon as shown by subsequent developments, as corroborative evidence of the overstatement of the liability.
>
> D. In the application of B of (sic) following method or verifying the reasonableness of the unpaid losses (exclusive of ocean marine) of companies doing business in fire insurance and allied lines, is suggested:
>
> A development of the outstanding losses of the current year alone, (or of the current year and one or more of the previous years at the election of the taxpayer) shall be used to ascertain the reasonableness of the liability as claimed. Where the amounts paid on the current year's losses (or on as many years as are used by the taxpayer) discloses that the estimate was not in excess of 115% of the amounts paid in respect thereto the estimates shall be considered as reasonable. Where such estimate was in excess of 115%, it will be considered excessive and an adjustment will ordinarily be required.
>
> E. Discrepancies of 15% between the estimate for unpaid losses and the amounts required to be paid thereon, will ordinarily be presumed to be reasonable variances due to the nature of the insurance business in general. . . .

This procedure is no longer followed. Rev. Proc. 75-76, 1975-2 C. B. 112, [should be, Rev. Proc. 75-56, 1975-2 C. B. 596] supersedes Mimeo R. A. 1366, and notes that "[t]he long term administrative practice enunciated in [the prior procedure] can no longer be justified in view of the technological advances made by the insurance industry in the area of statistical collection and analysis". Rev. Proc. 75-76, § 3.01. A standard of reasonableness in unpaid loss estimates is still applied; however, the 15% tolerance formerly allowed is no longer applicable.

8. In making such comparisons respondent applied a longer testing or development period for so-called Schedule P lines than for Schedule O lines of insurance in determining petitioner's experience rate'. Schedule P of the Annual Statement included Auto Liability, Liability other than Auto, and Workmen's Compensation. Schedule O covered most of the remaining lines of insurance. 69 T. C. 264-65.

by more than 15 percent, the deduction for the taxable year in question was presumed to overstate reality by the same proportion. The Commissioner would reduce the deduction allowed for the year at issue by a percentage equal to the percentage by which prior years' estimates were excessive by more than 15 percent. Thus, for example, if the "experience rate" (past estimates divided by actual losses) was 123 percent, the Commissioner would assume that the claimed deduction for the year at issue represented 123 percent of actual losses for that year. A loss deduction would be allowed only equal to 115 percent of the amount determined by the Commissioner to be the proper figure based on the taxpayer's experience rate.[9]

The Tax Court also heard evidence concerning audits of MBI's annual statements by the National Association of Insurance Commissioners. Those audits, conducted at three-year intervals by Massachusetts state officials together with N. A. I. C. representatives, showed significant overstatements in MBI's unpaid losses outstanding reserves for 1956 and 1959. However, MBI did not make adjustments to its books and accounts as a result of those audits.

The Commissioner presented testimony from "a well qualified actuary with much experience in the casualty insurance field"[10] before the Tax Court. This expert applied his own testing technique, which was different from that used by the Commissioner,

9. Thus, if a loss deduction of $30 million were claimed for the year in question, but the insurance company's experience rate theretofore was 123%, the Commissioner would allow a loss deduction for that year of only $28,048,779, computed as follows:

$$\frac{123}{100} = \frac{\$30,000,000}{\text{presumed actual losses}}, \text{ presumed actual losses} = \$24,390,243.$$

The Commissioner would allow up to 115% of presumed actual losses. (1.15) × ($24,390,243) = $28,048,779.

10. Hanover "takes exception" to the Tax Court's finding that the Commissioner's expert witness, Mr. David Skurnick, is "well qualified". We find no abuse of discretion in the Tax Court's admission of his testimony. *Salem* v. *United States Lines Co.*, 370 U. S. 31, 35 (1962).

to find significant overstatements in unpaid loss reserves for 1959, 1960, and the taxable period ending on June 30, 1961 comparable in magnitude to those determined by the Commissioner.[11]

The Tax Court set forth the following schedule[12] to demonstrate the development of MBI's unpaid losses for which deductions were claimed in 1959 and 1960, as compared with the amount of deductions allowed by the Commissioner:

	1959	1960
Unpaid losses claimed (per Annual Statement) by MBI	$30,390,690	$29,965,729
Subsequent development to 12/31/62 (actual losses)	$28,108,225(1)	$27,715,704(2)
Unpaid losses as adjusted by the Commissioner(3)	$29,286,116	$29,275,181

1. Includes unpaid losses on pooled business at full amount claimed by MBI, *i.e.*, $2,857,749.

2. Includes unpaid losses on pooled business at full amount claimed by MBI, *i.e.*, $3,189,724.

3. Balance of claimed losses after deducting the Commissioner's 1959 and 1960 adjustments of $1,104,574 and $690,548, respectively.

It should be noted that the adjustment made by the Commissioner was only for the purpose of determining the proper loss deduction for federal tax purposes and had no effect on the reserves actually held by MBI to cover payment of unpaid losses. The table set forth above merely demonstrates that, had MBI maintained reserves in accordance with the Commissioner's calculation rather than its own, it still would have had sufficient funds in reserve to cover unpaid losses arising from 1960 claims.

As we have indicated, the adjustment made by the Commissioner was the basis of the deficiency he assessed for 1960 which,

11. *See* 69 T. C. at 267.

12. *Id.* at 268.

in turn, was recomputed by the Tax Court and is the subject of this appeal.

Hanover first argues that it correctly computed its gross income on the basis of the underwriting and investment exhibit of the annual statement approved by the N. A. I. C. Because I. R. C. § 832(b)(1)(A) and Treas. Reg. § 1.832-1 require computation of insurance company income on this basis, Hanover claims that its computations are insulated thereby from adjustment by the Commissioner. It relies on this Court's decision in *Commissioner of Internal Revenue* v. *New Hampshire Fire Insurance Company*, 146 F. 2d 697 (1st Cir. 1945) in support of this contention.

Hanover's reliance on our decision in *New Hampshire Fire Insurance, supra,* is misplaced. In that case we merely enforced Congress's requirement that the N. A. I. C. form be followed as the only acceptable *method* for computing an insurance company's gross income. We recognized explicitly that "as a fundamental principle tax returns must represent income, and . . . returns based exclusively on the [N. A. I. C.] form do not." *Id.* at 700. Despite this recognition, we held that the form must be followed because Congress, when it imposed this requirement on insurance companies, was faced with the "axiomatic fact that insurance bookkeeping and accounting are highly complicated processes" and its choice of reliance on the N. A. I. C. form was the result of "an apparent search for a simple method for reporting income for tax purposes." *Id.*

There is no support in *New Hampshire Fire Insurance, supra,* for the contention that the mere inclusion of certain figures on the congressionally-approved annual statement can prevent the Commissioner's adjustment for the purpose of identifying tax deficiencies. As the Tax Court concluded in its denial of Hanover's motion to dismiss, accepting this position

> would entail our speculating and concluding that the First Circuit's blessing of the [N. A. I. C. form] . . . was tantamount to a sanctification of the estimated figures as well as the form itself, no matter how unfair or unreasonable.
>
> 65 T. C. at 719.

Hanover's reliance on *Western Casualty and Surety Company* v. *Commissioner,* 571 F. 2d 514 (10th Cir. 1978) is also misplaced. In that case the Tenth Circuit Court of Appeals considered the question of whether an insurance company may include as deductions commissions on deferred premium installments in its computation of "expenses incurred" using the N. A. I. C. form as required by I. R. C. § 832(b)(6). The Court held that

> the N. A. I. C. forms are not absolute and . . . where they conflict with the ordinary requirements of [I. R. C.] § 162 ["Trade or business expenses"], the latter prevails.
>
> . . .
>
> Deference to the N. A. I. C. would allow the deduction of commissions which had not been actually paid and were mere accounting entries.
>
> *Id.* at 517-18.

We must conclude that the Tax Court was correct in holding that MBI's adherence to the N. A. I. C. annual statement did not prevent the Commissioner from contesting the figures contained therein. Congress' "preference for N. A. I. C. accounting methods", *Commissioner* v. *Standard Life and Accident Insurance Company,* 433 U. S. 148, 161 (1977), should not be interpreted to inhibit the Commissioner's authority to enforce I. R. C. § 832. His inquiry into the validity and accuracy of the figures reported under that provision, guided by the standard of reasonableness found in Treas. Reg. § 1.832-1,[13] is a necessary step in his exercise of that authority.

Hanover's second contention is that the Commissioner's regulation enforcing I. R. C. § 832, Treas. Reg. 1.832-1, is violative

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13. Hanover also challenges the validity of the "reasonableness" standard contained in § 1.832-1. *See* discussion at 14-17, *infra.*

of the so-called McCarran-Ferguson Act, 15 U. S. C. § 1011 *et seq.* (1976). That law provides that no act of Congress may "be construed to invalidate, impair, or supersede any law enacted by any state for the purpose of regulating the business of insurance . . . unless such Act specifically relates to the business of insurance . . .". Hanover gives two reasons for its position: that the regulation and the Commissioner's enforcement procedure[14] do not, in the long run, increase federal tax revenues and therefore constitute an unwarranted intrusion upon the accounting practices of insurance companies; and the Commissioner's enforcement of Treas. Reg. § 1.832-1 subjected the unpaid losses of MBI to restrictions whereby the Commissioner could regulate this item in violation of the McCarran-Ferguson Act.

The court disagrees that enforcement of § 832 in the manner accomplished in this case does not increase federal tax revenues.[15] Although revenues lost through overstated deductions in a given year presumably will be recaptured in succeeding years, a consistent pattern of overstatement will result in a "float" or tax deferral which is of real advantage to a taxpayer and corresponding disadvantage to the federal treasury. It can amount to an interest-free loan from the federal government.[16]

14. *See* notes 5 and 7, *supra.*

15. Even if this contention were valid, it does not necessarily follow that enforcement of Treas. Reg. § 1.832-1 constitutes regulation of the insurance industry; the absence of financial benefit to the government seems irrelevant to the question of whether there is a regulatory effect on the industry.

16. Hanover relies on *Continental Insurance Company* v. *United States,* 474 F. 2d 661 (Ct. Cl. 1973), wherein the Court of Claims ruled on the propriety of an insurance company's exclusion of certain items from salvage recoverable adjustments to losses deducted from gross income pursuant to I. R. C. § 832. The issue was whether such adjustments should include paid salvage recoveries or estimates of recoveries to be realized in the future. The court upheld the taxpayer's exclusion and noted that

> . . . in the long run it will make no substantial difference in the amount of taxes paid whether salvage recoveries are treated on a "paid" basis or whether estimates are required to be made.

(Footnote continued on next page.)

Hanover contends that Treas. Reg. § 1.832-1(b) gives IRS District Directors a "visitorial power" to review unpaid losses claims and thereby allows improper regulation in violation of the McCarran-Ferguson Act. This argument fails for two reasons. First, I. R. C. § 832 "specifically relates to the business of insurance"—it deals exclusively with taxation of insurance companies—and, therefore, the McCarran-Ferguson Act is inapplicable by its own terms. Because "the power of the federal government to tax was not delegated to the states" by the Act, *Industrial Life Insurance Company* v. *United States,* 481 F. 2d 609, 610 (4th Cir. 1973), the application of federal tax laws to insurance companies is not inconsistent with the intent of Congress to refrain from interfering with state regulation of the insurance business. *See United States* v. *Sylvanus,* 192 F. 2d 96 (1st Cir. 1951) (McCarran-Ferguson Act did not prevent enforcement of federal statute punishing mail fraud).

In addition, we cannot accept Hanover's contention that enforcement of Treas. Reg. § 1.832-1(b) constitutes regulation. MBI was free to maintain reserves in any amount for unpaid losses. I. R. C. § 832 and accompanying regulations do not limit

(Footnote continued from preceding page.)

> Sooner or later salvage recoveries must be taken into income for tax purposes. Thus, there is no question of tax avoidance presented here, but merely a question of when salvage is to be taken into account for purposes of the federal income tax. *Id.* at 671.

In allowing this exclusion, the Court of Claims was mindful of the need for uniformity in treatment of salvage items throughout the states. Relevant Treasury Regulations provided that "if any state in which an insurer did business excluded estimates of future salvage recoveries . . . such estimates would be excluded for federal income purposes." *Id.* at 668.

To the extent that the Court of Claims found "no significant offsetting advantage to the government" in allowing taxpayer's exclusions and resultant reduction of its taxable income, we find *Continental Insurance, supra,* inapplicable to the present case. For example, given the deficiency of $331,664.28 assessed here and an annual interest rate, before compounding, of 7%, the disadvantage in delayed receipt of these funds of one year amounts to $23,215.10 —not an insignificant figure.

an insurance company's freedom to keep records in whatever manner it chooses for financial or state regulatory use. Any increased burden on the insurance company is no greater than that borne by other taxpayers who use different data for tax purposes as opposed to other purposes.

Hanover challenges directly the validity of Treas. Reg. § 1.832-1 because, by purporting to authorize the Commissioner to determine whether unpaid loss deductions exceed "a fair and reasonable estimate of the amount the company will be required to pay" and to assess tax deficiencies based upon such determinations, the regulation allegedly exceeds the scope of the statute it interprets, I. R. C. § 832. Because this statute does not empower explicitly the Commissioner to apply it according to a "fair and reasonable" requirement, Hanover's argument is that there is no authority for such a requirement and that the regulation is invalid to that extent.

In support of its argument Hanover relies on cases holding that there is no power in an administrator to construe an unambiguous statute, *see, e.g., United States* v. *Fisher,* 6 U. S. (2 Cranch) 358 (1804); *Dollar Savings Bank* v. *United States,* 86 U. S. (19 Wall.) 227 (1874); *Swift Company* v. *United States,* 105 U. S. 691 (1882), together with cases in which tax regulations have been struck down because of direct conflict with specific provisions of the Code. *See, e.g., Koshland* v. *Helvering,* 298 U. S. 441 (1936). These authorities are inapposite for two reasons. First, I. R. C. § 7805 specifically empowers the Secretary of the Treasury, or his delegate, to "prescribe all needful rules and regulations for the enforcement" of Code provisions. The United States Supreme Court has indicated that "regulations promulgated under [the Secretary's] authority, if found to 'implement the congressional mandate in some reasonable manner' must be upheld." *United States* v. *Cartwright,* 411 U. S. 546, 550 (1973) (citations omitted); *Commissioner* v. *Winslow,* 113 F. 2d 418, 423 (1st Cir. 1940). The regulation in question clearly meets this test; Treas. Reg.

§ 1.832-1 reflects explicitly the computation method for losses and gross income which is set forth in the statute, I. R. C. § 832. By providing that District Directors may determine whether deductions "can be said to represent a fair and reasonable estimate of the amount the company will be required to pay," the regulation does no more than give notice to the taxpayer that the Code will be enforced pursuant to the mandate of § 7805. To hold otherwise would vitiate this section of the Code; insurance company taxpayers could deduct any amount calculated according to the method in § 832(b) and claim immunity from administrative review. Clearly this was not the intent of Congress.[17]

Moreover, Hanover ignores the fundamental premise that taxpayers must prove their entitlement to deductions. There is no burden on the Commissioner to justify his disallowance of a claimed deduction. *New Colonial Company* v. *Helvering,* 292 U. S. 435, 440 (1934); *Welch* v. *Helvering,* 290 U. S. 111, 115 (1933). The regulation at issue here restates that principle, providing that insurance companies "must be prepared to establish" the validity of their loss deduction reserves "in amounts which, based upon the facts in each case and the company's experience with similar cases," are close to actual experience. The imposition of this requirement on insurance company taxpayers is not an impermissible expansion upon I. R. C. § 832.

Alternatively, Hanover claims to have suffered a denial of due process by the Commissioner's application of Treas. Reg. § 1.832-1 to MBI. Its argument is that I. R. C. § 7805, which delegates authority to issue regulations under the Code, contains

17. The validity of the regulation is also supported by "the settled principle that 'Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law'." *United States* v. *Correll, supra,* 299 U. S. at 305-306 (citations omitted). As the Commissioner points out, the regulation or its substantially similar predecessors have been in existence for over 34 years. Appellee's Brief at 28.

insufficient standards for the exercise of that authority. Therefore, Hanover contends, this delegation of legislative authority operated to deprive MBI of property without due process.

Hanover relies on *Panama Refining Company* v. *Ryan*, 293 U. S. 388 (1935) and the old war horse of *Schechter Poultry Company* v. *United States*, 295 U. S. 495 (1935), both cases in which the Supreme Court invalidated New Deal legislation which delegated legislative authority to administrative bodies without sufficient standards or policies to govern the administrative exercise of that authority. Because there is no requirement of "reasonableness"pertaining to unpaid loss deductions in I. R. C. § 832(b), Hanover contends that the promulgation of Treas. Reg. § 1.832-1 was not "needful" within the meaning of I. R. C. § 7805. Thus the regulation, which does require that loss deductions be "fair and reasonable" estimates of actual losses, constitutes an expansion of § 832 not governed by a statutory standard. This, it claims, is a denial of due process.

This argument is frivolous. The Supreme Court has made repeated reference to Congress' delegation of authority under I. R. C. § 7805. *See, e.g., United States* v. *Cartwright, supra,* 411 U. S. at 550; *Bingler* v. *Johnson,* 394 U. S. 741, 750-751; *United States* v. *Correll,* 389 U. S. 299, 306-307. Standards for the exercise of this power are found in the substantive provisions of the Code which are enforced by the regulations in question. I. R. C. § 7805 explicitly requires that regulations be "needful . . . for enforcement" of the Code. "The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate [of § 7805] in some reasonable manner." *United States* v. *Correll, supra,* 299 U. S. at 307.

Clearly, the purpose of I. R. C. § 832(b)(5) is the accurate computation of losses incurred, and an element of the requisite calculation is the "unpaid losses outstanding" figure. Treas. Reg. § 1.832-1 does no more than require that the amount of unpaid losses estimated and deducted by insurance companies should

comport with reality. Where the Code explicitly allows deduction of an item which cannot be valued precisely at the time the deduction is claimed, no more reasonable manner of implementing Congress' purpose can be found than a regulation which requires the deduction to be a "fair and reasonable" estimate of actual experience. It is spurious to suggest that in so doing the Commissioner has acted without the benefit of the Congressional direction contained in § 832 itself.

In a final challenge to the assessment of this deficiency Hanover claims that its determination of unpaid loss reserves was, in fact, accurate and that the Commissioner's adjustment was in error and reached in violation of his own regulation. For the reasons set forth below, we find this claim to be without merit.

The determination of a fair and reasonable estimate of a taxpayer's unpaid losses in essentially a valuation issue and a question of fact. Thus, the scope of our inquiry is limited to deciding whether the Tax Court's determination on this issue was clearly erroneous. *Commissioner* v. *Duberstein,* 363 U. S. 278, 291 (1960). As we have noted, it was Hanover's burden to prove its entitlement to a deduction beyond that allowed by the Commissioner. *Welch* v. *Helvering, supra,* 290 U. S. at 115.

The Tax Court heard ample evidence of MBI's overstatement of unpaid loss reserves. Apart from the financial data submitted by the government on this point,[18] the N. A. I. C. itself, in examinations conducted in 1956 and 1959, had determined that MBI's losses were overstated. In addition, the Commissioner's expert testified that, in his opinion, MBI's reserves were "unreasonably high." In response to this evidence, MBI merely relied on its own computation methods.[19]

Having examined the record and financial data presented by the parties, we cannot say that the Tax Court's determination

18. This data is found at pp. 628-631 of the record appendix.

19. See n. 6, *supra.*

was clearly erroneous. While Hanover has attempted to show that the reserves allowed by the Commissioner resulted in understatement of developed losses, it has done so based on the assumption that the Commissioner allowed only 100% of what he determined to be actual losses for 1960. In fact, the Commissioner allowed 115% of actual losses (as determined according to Mimeo RA 1366), and a comparison of his allowance with actual experience demonstrates that it adequately covered actual losses for 1960.[20]

Finally, Hanover contends that the Commissioner violated Treas. Reg. § 1.832-1(b) because he did not examine each of MBI's cases to determine whether the Company's loss estimates were reasonable. This argument misses the mark because the regulation does not require the Commissioner to undertake such an analysis. It provides that the taxpayer "must be prepared to establish" that its unpaid loss deduction "comprises only actual losses stated in amounts which, based upon the facts in each case and company's experience with similar cases" are fair and reasonable estimates. The Commissioner's method of ascertaining deductions he will allow is not circumscribed by the regulation.

In conclusion, we find that MBI's unpaid loss deduction was not insulated from the Commissioner's review by I. R. C. § 832, and that the McCarran-Ferguson Act does not bar application of this Code section to insurance companies through Treas. Reg. § 1.832-1. We reject Hanover's arguments regarding the validity of that regulation, and we find that the decision of the Tax Court upholding a recomputed deficiency for 1960 was not clearly erroneous.

The decision of the Tax Court is, therefore, affirmed.

20. See p. 14 [A14], *supra*.

APPENDIX B

UNITED STATES COURT OF APPEALS
For the First Circuit

No. 78-1407.

HANOVER INSURANCE COMPANY, ETC.,
Petitioner, Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent, Appellee.

JUDGMENT

Entered May 8, 1979

This cause came on to be heard on appeal from the United States Tax Court, and was argued by counsel.

Upon consideration whereof, It is now here ordered, adjudged and decreed as follows: The decision of the Tax Court is hereby affirmed.

By the Court:

/s/ DANA H. GALLUP,
Clerk.

APPENDIX C

FINAL OPINION OF THE UNITED STATES TAX COURT [69 T. C. 260]

UNITED STATES TAX COURT

HANOVER INSURANCE COMPANY, SUCCESSOR IN INTEREST TO: MASSACHUSETTS BONDING AND INSURANCE COMPANY, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 1557-71. Filed November 22, 1977.

Held, respondent correctly recomputed the amount of the reserves for unpaid losses carried by petitioner's predecessor, a casualty insurance company, at the end of 1959, 1960, and the period ending June 30, 1961 (which losses are included in the computation of "losses incurred" under sec. 832(b)(5), I. R. C. 1954). *Held, further*, petitioner's 1958 yearend reserve for unpaid losses adjusted under sec. 481, I. R. C. 1954.

Paul A. Teschner, for the petitioner.

Williard J. Frank and *W. Terrence Mooney*, for the respondent.

OPINION

WILES, *Judge:* This case was assigned to Special Trial Judge Lehman C. Aarons (pursuant to Rules 180, et seq., of the Tax Court Rules of Practice and Procedure) to conduct the trial thereof or otherwise proceed in accordance with said Rules. His report was filed on July 15, 1977, and subsequently both parties filed exceptions to his report. The exceptions have been considered and are rejected. The Court agrees with and adopts the report set forth below.

OPINION OF THE SPECIAL TRIAL JUDGE

AARONS, *Special Trial Judge:* Respondent determined deficiencies in petitioner's[1] Federal income tax for the taxable years ended December 31, 1959 and 1960, in the respective amounts of $441,081.10 and $446,206.34. The taxable period ended June 30, 1961, is also involved because of respondent's adjustment of a net operating loss for that period which was carried back to 1959. Although respondent, in an amendment to his answer, claimed increased deficiencies such increases have been conceded by respondent.

The issues remaining for decision are (1) whether the reserves for unpaid losses carried by petitioner at the end of 1959, 1960, and the period ending June 30, 1961 (which are included in the computation of "losses incurred" under section 832(b)(5)), were unreasonable in amount and were properly reduced by respondent, and (2) if (1) is answered in the affirmative, whether a comparable reduction must be made to the reserve for unpaid losses carried by petitioner at the end of 1958, and deducted (under sec. 832(b)(5)) in determining 1959 losses incurred.[2]

1. "Petitioner," as used hereinbelow, refers to Massachusetts Bonding & Insurance Co., the predecessor of Hanover Insurance Co.

2. Petitioner continues to urge the invalidity of sec. 1.832-4(b) (formerly sec. 1.832-1(b)), Income Tax Regs. Although, indeed, that contention appears to constitute the major thrust of petitioner's opening brief, it is not an issue now before the Court; it was adjudicated at an earlier stage of this case in *Hanover Insurance Co.* v. *Commissioner*, 66 T. C. 715 (1976).

FINDINGS OF FACT

Many of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated by this reference. Only those facts necessary for an understanding of the opinion will be summarized below.

Petitioner was a casualty insurance company having its principal office in Massachusetts. The returns for the years involved were filed with the District Director, Boston, Mass. Such returns were for the calendar years 1959 and 1960 and for the period ending June 30, 1961. Petitioner was merged into Hanover Insurance Co., and went out of existence as of June 30, 1961. Hanover Insurance Co., likewise has its principal office in Massachusetts.

Petitioner, during the period here at issue, wrote 24 lines of casualty (non-life) insurance. Petitioner filed annual statements with the Insurance Department of the Commonwealth of Massachusetts on the form approved by the National Association (formerly National Convention) of Insurance Commissioners (NAIC). With relatively negligible exceptions (which are not here at issue), petitioner computed its taxable income for each period here involved on the basis of the net income shown at line 20 of the underwriting and investment exhibit of such annual statement.

In arriving at its net income for annual statement purposes (and its gross profit for Federal income tax purposes), one of the principal deductions claimed by petitioner was "losses incurred." "Losses incurred" as claimed by petitioner for the years 1959 and 1960, and the period ended June 30, 1961, were respectively $19,264,486, $21,067,480, and $8,925,671. Basically, those figures were determined by adding to "losses paid-current year" the amount of "unpaid losses outstanding—current year" and deducting therefrom the amount of "unpaid losses —prior year."

The disputed adjustments (which result in reduction of "losses incurred") relate to the "unpaid losses" outstanding at the end of the periods here involved. The aggregate amounts of such unpaid losses (for all lines of insurance) claimed by petitioner and the aggregate adjustments asserted by respondent are:

	Claimed	*Respondent's net reduction*
Dec. 31, 1959	$30,390,690	$1,104,574
Dec. 31, 1960	29,965,729	690,548
June 30, 1961	27,415,563	113,180

In determining the amounts of the foregoing net reductions, respondent gave credit for the prior reductions in conformity with the requirement of the Internal Revenue Code that, in determining losses incurred, unpaid losses at the end of the preceding year are to be deducted from the sum of losses paid during the taxable year and unpaid losses outstanding at the end of the taxable year. However respondent made no adjustment to the unpaid losses claimed by petitioner as of the end of 1958 in the aggregate amount of $31,257,371. The aggregate amount of unpaid losses claimed by petitioner at the end of 1953, according to its annual statement for that year, was $30,097,672.

Petitioner used two basic methods to determine its reserves for unpaid losses. The so-called individual case method was used wherever possible; if not possible, a formula method was used. Under the case method, petitioner's home office claims examiner after receiving a report from the field, would establish a dollar value on estimated liability with respect to each case. The claims examiner was supposed to take into account a myriad of factors such as the severity of the injury or occurrence; negligence and contributory negligence; age, health, personal and emotional factors; location of the occurrence and the effect of local law; identity of lawyers; and other imponderable factors. The volume of individual cases was heavy. The only claims examiner who testified at the trial, examined as many as 150 claims per day.

Establishment of case reserves of $1,000 or more required approval of petitioner's claims vice president. As further reports were received from the field the examiner would revise the case reserve upwards or downwards. The total amount of the case reserves was determinable at any time from the computer. No yearend adjustments were made to such reserves, nor (except as noted above) were changes in such reserves made by anyone at any time. It was contrary to petitioner's policy to inform claims examiners of their past performance based on development figures of previous loss claims.

Petitioner's primary use of a formula method of reserving for unpaid losses (i.e., the second basic method used by petitioner to determine such reserves) was with respect to liability for occurrences which presumably had already taken place but which had not yet been reported to the claims department. IBNR (incurred but not reported) reserves were tentatively established by multiplying the premiums in force at the end of the accounting period by the ratio of the prior 2 years' average IBNR losses as developed over a 21-month period, to the average premiums in force during the current period. This tentative figure was then revised to take into account variables such as inflation and changes in rates. IBNR reserves constituted approximately 18 percent of the total claimed unpaid losses for 1959, and approximately 28 percent for 1960 and for the period ended June 30, 1961.

In connection with its business done through "pools" (syndicates formed to spread risks among several companies), petitioner also used a formula reserve figure which was supplied to it by the pool. Pools were separately audited, and were likewise regulated by NAIC. Petitioner did not make any independent investigation of its pooled claims. Pooled unpaid loss reserves constituted approximately 9 percent of petitioner's total claimed unpaid losses for 1959 and approximately 11 percent for 1960.

A formula was also used by petitioner in miscellaneous other situations. For example, to avoid unnecessary and unproductive

paperwork so-called "notice claims" (e.g., claims up to $500 for auto property damage) were reserved by petitioner's statistical department on an actuarial basis. "Notice claims" constituted approximately 2 percent of petitioner's total claimed unpaid losses.

Respondent's method of testing the reasonableness of petitioner's unpaid loss reserves was based on the development (i.e., actual payments in subsequent years) of prior years' claimed unpaid losses. If a comparison between the current year's estimate and past years' experience in the same line of insurance indicated a current year overstatement of more than 15 percent, respondent reduced the current year's estimate to 115 percent of the average past years' experience.

In making such comparisons respondent applied a longer testing or development period for so-called Schedule P lines than for Schedule O lines of insurance in determining petitioner's "experience rate." Schedule P of the annual statement included auto liability, liability other than auto, and workmen's compensation. Schedule O covered most of the remaining lines of insurance.

As to Schedule O, respondent's testing method applicable to the years before the Court is summarized as follows in Mim. R. A. No. 1366, issued by the Commissioner of Internal Revenue on July 1, 1944:

> Information that will disclose the reasonableness of the unpaid loss liability as set up by the taxpayer may be secured from Schedule O of the Annual Statement. A comparison of the amounts paid in the first succeeding year plus the amount still estimated as unpaid at the end of such year, (developed losses) should be made with the previous year's estimate of unpaid losses (estimated losses) to determine the ratio of "estimated losses" to one-year "developed losses." Such comparison should be made separately for each year for the previous five years. If the average "estimated losses" of the previous five years is found to be not more than 115 percent of the five-year

> average of the one-year "developed losses," the estimates made will be regarded as being reasonably correct, and no adjustment for the current year would ordinarily be required.
>
> In the event that the five-year average of "estimated losses" is in excess of 115 percent of the five-year average of the one-year "developed losses" then the unpaid loss liability of the company will be deemed to be excessive in the current year and an adjustment will ordinarily be required. * * *

With respect to Schedule P, respondent applied a similar testing method, but because Schedule P lines represented personal injury type claims that require a longer development in order to ascertain actual loss, a 5-year average of five years' development was used by respondent rather than a 5-year average of 1 year's development as in the case of Schedule O. For example, in adjusting the 1959 unpaid losses outstanding for workmen's compensation, the claimed unpaid losses outstanding for each of the years 1950 through 1954 were compared to the development of those claimed unpaid losses outstanding as derived from the 1955 through 1959 annual statements. The unpaid losses outstanding claimed as of 1950 were developed to 1955, unpaid losses outstanding claimed as of 1951 were developed to 1956, and so forth. The average of these experience rates was used to adjust the 1959 claimed unpaid losses for workmen's compensation.

In each line of insurance, for each of the years involved, where the overstatement thus ascertained by comparison with prior experience exceeded the 15-percent tolerance, an adjustment was made by respondent down to the 15-percent tolerance point. Thus, if the applicable ratio of claimed unpaid losses to developed losses (the "experience rate") was 123 percent (as in the case of workmen's compensation), respondent adjusted the 1959 claimed unpaid losses to a figure representing 115 percent of the figure determined by respondent to be the proper figure based on petitioner's experience rate. In the case of lines showing an experience rate of claimed unpaid losses to developed losses of less than 115 percent, no adjustment was made by respondent.

There were no instances in which respondent determined an understatement of unpaid losses. However, there were only rare instances of lines of insurance where the "experience rate" of petitioner was under 100 percent, and there were no instances during the years before the Court, where the "experience rate" thus computed by respondent (i.e., the ratio of estimated unpaid losses to developed losses) was less than 85 percent.

The NAIC made audits of petitioner's annual reports every 3 years for the primary purpose of determining petitioner's solvency and ability to pay its claims. (Such audits were actually made by the Division of Insurance of the Massachusetts Department of Banking and Insurance, and participating representatives of NAIC. They were commonly referred to as "convention examinations" and are referred to herein as NAIC examinations.) In its report of examination for 1956 and 1959, NAIC determined that petitioner's unpaid losses outstanding should be decreased in the respective net amounts of $2,076,181.86 and $1,093,175. According to petitioner's witnesses, petitioner regarded NAIC examinations "seriously." However, petitioner never made adjustments to its books and accounts as a consequence of the adjustments made by NAIC auditors. There is no substantial correlation on a line by line basis between the NAIC adjustments and respondent's adjustments.

Respondent's expert witness, David Skurnick, is a well-qualified actuary with much experience in the casualty insurance field. He applied a testing technique which differed from that applied by respondent in that the loss development of prior years was compared by Mr. Skurnick to a base consisting of premiums in force (or in automobile lines, earned premiums) rather than to the base of claimed unpaid losses (used by respondent), for the 5 year series of years prior to the year at issue. An average of the ratios of claimed unpaid losses to premiums in force (or

earned) in each of the lines of insurance was then applied by Mr. Skurnick to the premiums in force (or earned) in the taxable year in order to determine the proper unpaid loss reserve for the taxable year.

Mr. Skurnick's method indicated aggregate overstatements as follows:

	1959	1960	1961
Total overreserved lines	$3,974,279	$3,785,112	$2,729,093
Total underreserved lines	261,360	0	170,841
Net overstatement	3,712,919	3,785,112	2,558,252

Respondent's method of testing petitioner's reserves for unpaid losses indicated aggregate overstatements, *before allowing the 15-percent tolerance*, as follows:

1959	$4,463,344
1960	5,313,739
1961	5,130,229

Mr. Skurnick acknowledged that there are many methods of testing the reasonableness of reserves for unpaid losses and that no single method is "the correct method." He viewed respondent's method as being less accurate than his own method because respondent's method would not give credit for any correction in a past reserve inaccuracy. However, in this case, he felt that because petitioner has been reserving "consistently," this defect in method did not distort the results of respondent's method. Mr. Skurnick also expressed the opinion that the 15-percent tolerance allowed by respondent "makes the IRS method conservative." It was also his opinion that under his own method "The stability of the ratios of reserve runoff [development] to premiums indicates that a smaller tolerance would be satisfactory." In his opinion a 5-percent tolerance is adequate under his method.

As to the individual case method used by petitioner, Mr. Skurnick's view was that "the case reserve will be fairly accurate as long as there is no bias in the individual reserves" but that the existence of bias is very common. Further, he pointed out that

some other method must be applied to IBNR since the individual case method provides only for the reserve of known claims.

The following schedule sets forth the subsequent development (to December 31, 1962) of petitioner's total unpaid losses for all lines of insurance as claimed by petitioner for 1959 and 1960, in comparison with the amount of the reserve balance remaining after respondent's adjustment:

	1959	1960
Unpaid losses claimed (per annual statement) by petitioner	$30,390,690	$29,965,729
Subsequent development to 12/31/62	[1]28,108,225	[2]27,715,704
Unpaid losses as adjusted by respondent[3]	29,286,116	29,275,181

1. Includes unpaid losses on pooled business at full amount claimed by petitioner, i.e., $2,857,749.

2. Includes unpaid losses on pooled business at full amount claimed by petitioner, i.e., $3,189,724.

3. Balance of claimed losses after deducting respondent's 1959 and 1960 adjustments of $1,104,574 and $690,548, respectively.

OPINION

There are two issues to be decided by the Court: (1) The propriety of respondent's adjustments to petitioner's unpaid loss reserves as of December 31, 1959, December 31, 1960, and June 30, 1961, and (2) if respondent is sustained as to (1), the propriety of respondent's failure to make a corresponding adjustment to petitioner's unpaid loss reserve as of December 31, 1958.

Issue 1. "Unpaid Loss" Deductions for Taxable Years and Taxable Period at Issue

During the years and period here at issue, petitioner[3] was a casualty insurance company taxable under section 831 of the

3. See n.1 *supra*.

Code.[4] Section 832(b)(1)(A) defines "gross income" of companies subject to tax under section 831 as including

> (1) GROSS INCOME.—The term "gross income" means the sum of—
>
> (A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners * * *

The term "underwriting income" is defined in section 832(b)(3) as meaning premiums earned less "losses incurred and expenses incurred." Section 832(b)(5) defines "losses incurred" as follows:

> (5) LOSSES INCURRED.—The term "losses incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:
>
> (A) To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year.
>
> (B) To the result so obtained, add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year.

Since 1941, the regulations (as now embodied in sec. 1.832-4(a)(5) and 4(b), Income Tax Regs.) have addressed themselves to the subject of "unpaid losses" in the following terms:

> 4(a) * * *
>
> (5) In computing "losses incurred" the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them.

4. Statutory references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

> (b) Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for "losses incurred" which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and the company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of such losses which, in the opinion of the district director are in excess of the actual liability determined as provided in the preceding sentence will be disallowed as a deduction. The district director may require any such insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for "losses incurred."

The Court sustained the validity of this regulation in *Hanover Insurance Co.* v. *Commissioner*, 65 T. C. 715 (1976). All that remains here to be decided (under Issue I.) is whether respondent's adjustments to petitioner's yearend estimates of unpaid losses were justified under the "fair and reasonable" test imposed by the regulation.

Petitioner, wherever possible, used the individual case method of estimating unpaid losses. These estimates were revised from time to time on the basis of developments in the particular case, but the total reserves were not tested by petitioner on the basis of prior experience. Respondent tested the reasonableness of petitioner's unpaid loss reserve for each year and the taxable period at issue, by an "experience rate" testing technique which had been in use since 1944, as follows: for each of the separate lines of insurance coverage, respondent compared the unpaid loss reserves established in years prior to the year under examination with the loss actually paid with respect to such years.[5] For each

5. For the lines of coverage listed on Schedule O, the 5-year periods immediately preceding each of the years at issue were used. For the lines listed on Schedule P, respondent used the 10th through the 6th years preceding each of the years at issue.

line of coverage where this comparison showed that a reserve in prior years had been overstated by an average of more than 15 percent, the reserve in that line for the year under examination was reduced to the 15 percent "tolerance" figure.

The issue before the Court is essentially a valuation issue, i.e., the assignment of a fair and reasonable value to "unpaid losses," and the petitioner has the burden of proving the respondent's determination to be wrong. *Welch* v. *Helvering*, 290 U. S. 111 (1933); Rule 142(a), Tax Court Rules of Practice and Procedure. Section 1.832-4(b), Income Tax Regs., specifically places the burden upon the petitioner to establish "to the satisfaction of the district director" that the "unpaid losses" component of "losses incurred" comprises "actual unpaid losses." Having sustained the validity of this regulation in *Hanover Insurance Co.* v. *Commissioner, supra*, it clearly follows that the burden of proving error in respondent's determination rests upon the petitioner.[6]

Petitioner has not succeeded in carrying that burden. Petitioner's direct proof consisted primarily of a description of the methods it used in placing a dollar figure on its estimated liability on each case reported to it. The greater part of its loss reserves was the aggregate amount of such individual case reserves. Theoretically and ideally, the aggregate of the individual case reserves should equal a fair and reasonable total reserve. But the only individual claims examiner who testified for petitioner stated that she set up reserves on as many as 150 cases per day. If she had worked an 8-hour day without interruption, that would indicate an average of approximately 3 minutes per claim. While it is true that this witness did not

6. Indeed, it might well be argued, in the light of the language of the regulation, that petitioner bears the burden of showing not only that its unpaid loss reserves were reasonable but also that the respondent's adjustments constituted an abuse of discretion. Such a contention would be based upon the analogy of the bad debt reserve cases. See, e.g., *Westchester Development Co.* v. *Commissioner*, 63 T. C. 198, 211 (1974). However, it is not here held that petitioner bears this double burden.

handle the "heavy" personal injury cases, the Court is left to surmise how such examiners were able to apply in practice the myriad of factors to which petitioner's officers attached importance in the evaluation of claims.

It appears to be true, as respondent's expert witness conceded, that there are many methods for testing the reasonableness of unpaid loss reserves. But the evidence in this case does not establish that with respect to the bulk of its reserve, i.e., the aggregate of its individual case reserves, the petitioner employed any method of doublechecking or testing the aggregate amounts set aside.

Petitioner argues that if it had actually set aside the amounts of unpaid loss reserves deemed proper by respondent, the subsequent development of such losses would have created a deficit, and the reserves would have been insufficient to meet loss claims. But the figures used by petitioner to illustrate this point do not take into account the 15-percent tolerance allowed by respondent.[7] This tolerance figure was an integral factor in respondent's testing technique for the taxable periods here at issue. After taking the tolerance factor into account, the 1959 and 1960 reserves allowed by respondent exceeded the unpaid losses for those years (as developed to December 31, 1962) by $1,177,891 and $1,559,477, respectively. As recently stated by this Court in *Western Casualty & Surety Co.* v. *Commissioner*, 65 T. C. 897, 919 (1976), on appeal (10th Cir., June 17, 1976), respondent's test of reasonableness should be directed at the total unpaid loss reserve. In the light of the respondent's tolerance factor, petitioner has not demonstrated error in respondent's method. In so holding, there is no implication that

7. Under respondent's current procedure (see Rev. Proc. 75-56, 1975-2 C. B. 596), respondent stated that, because of technological advances made by the insurance industry, he can no longer justify the use of the 15-percent tolerance factor. No opinion is expressed herein as to respondent's current position reflected by Rev. Proc. 75-56.

petitioner acted otherwise than in good faith, that it deliberately undertook to overstate its reserves for unpaid losses, or that petitioner was in any way "mismanaged" (as asserted by respondent). It is held simply that petitioner failed to persuade the Court that respondent's method of testing the reasonableness of such reserves was itself an unreasonable testing method.[8]

A final comment seems to be appropriate as to the basic legal issue in this case. As indicated at the outset, petitioner's primary contention in its opening brief was the reiteration of the argument made in *Hanover Insurance* v. *Commissioner, supra,* that the figures shown on the NAIC form of the Annual Statement are legally binding and conclusive on respondent and that section 1.832-4(b), Income Tax Regs., is invalid. It is worthy of note that two of the findings proposed in petitioner's opening brief are:

> 3.68 Mass. Bonding [petitioner] regarded the N. A. I. C. examination seriously and not as perfunctory or merely routine.
>
> 3.69 Although the N. A. I. C. examiners did make adjustments to Mass. Bonding's reserves for Unpaid Losses Outstanding, Mass. Bonding never made adjustments to its books and accounts as a consequence of those adjustments.

In successive breaths, the petitioner (1) insists on the sanctity of the Annual Statement, (2) states that the examinations by the regulatory authorities are taken seriously, and (3) that no adjustments were made by petitioner despite the examiners' findings of very substantial overstatements of reserves for unpaid losses (albeit, mostly in lines of coverage different from those adjusted herein by respondent). This sequence of nonsequiturs

8. The Court is not here faced with the problem presented in *Western Casualty & Surety Co.* v. *Commissioner,* 65 T. C. 897, 919 (1976), on appeal (10th Cir., June 17, 1976), of respondent's failure to make an upward adjustment where the reserve was understated by more than 15 percent. The evidence in this case does not disclose any instance where the reserve was understated by more than 15 percent.

serves to reaffirm the correctness of the Court's 1976 opinion in this case.

Issue II. "Unpaid Loss" Adjustment as of December 31, 1958

During the trial of this case, the Court requested counsel, in their briefs, to comment upon the question whether respondent's adjustments of petitioner's reserves for unpaid losses effectuate a change in method of accounting, and whether section 481 of the Code is applicable. Petitioner's opening brief appears to argue against the applicability of section 481 although its reply brief asserts that respondent's adjustments constituted a change in method of computing unpaid loss reserves. Respondent's opening brief does not cite section 481, but in his reply brief respondent argues that the adjustments were not tantamount to a change in method, and that section 481 does not apply.

Section 481[9] prescribes the rules of computation of taxable income under a "method of accounting" different from the method employed by the taxpayer. Its purpose is to prevent any income from escaping tax or being doubly taxed solely because of such change in method. If the change in method was initiated by the Internal Revenue Service, amounts applicable to pre-1954 years should not be taken into account. Section 481 does not define "change in method of accounting." But section 1.446-

9. SEC. 481. ADJUSTMENTS REQUIRED BY CHANGES IN METHOD OF ACCOUNTING.

(a) GENERAL RULE.—In computing the taxpayer's taxable income for any taxable year (referred to in this section as the "year of the change")—

> (1) if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then
>
> (2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer.

1(e)(2)(ii)(a), Income Tax Regs., states that a "change in method of accounting" includes "a change in the treatment of any material item." Under those regulations: "A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction." Sec. 1.446-1(e)(2)(ii)(a), Income Tax Regs.; *Schuster's Express, Inc.* v. *Commissioner*, 66 T. C. 588, 594-595 (1976), affd. per curiam ..... F. 2d ..... (2d Cir. 1977, 40 AFTR 2d 77-5293, 77-2 USTC par. 9495); *Western Casualty & Surety Co.* v. *Commissioner, supra* at 912 et seq.

The statutory scheme for determining "unpaid losses" is akin to an inventory type of accounting in that the deduction for each year is the sum of losses paid during the year plus unpaid losses at the end of the year minus unpaid losses at the end of the preceding year. In the case of adjustments by respondent based upon his rejection of a longstanding and continuing practice of undervaluation of inventory, this Court has held that such adjustments constituted a change in method of accounting, obviously initiated by the respondent. *Fruehauf Trailer Co.* v. *Commissioner*, 42 T. C. 83, 105 (1964), affd. on another issue 356 F. 2d 975 (6th Cir. 1966), cert. denied 385 U. S. 822. Contrast *Korn Industries, Inc.* v. *United States*, 532 F. 2d 1352 (Ct. Cl. 1976), where the Court of Claims held that an accountant's error over a 4-year period in omitting 3 out of 14 elements of cost in valuing inventory was more analogous to a mathematical or posting error than to a change in accounting method. But note Rev. Rul. 77-134, 1977-18 I. R. B. 11, in which respondent (seemingly at odds with the position he has taken in the instant case as to the applicability of section 481) disagrees with *Korn Industries* on the ground that any change in a consistent pattern of inventory valuation is a "change in method" of accounting. And in the same vein, note example 7 of section 1.446-1(e)(2)(iii), Income Tax Regs., stating that a longstanding practice of undervaluing inventories is a method of accounting, and a change is such practice involves the treatment of a

material item used in the overall practice of valuing inventory, and constitutes a change in method of accounting.

The applicability of *Schuster's Express, Inc.*, and *Western Casualty & Surety Co., supra*, has also been considered. *Schuster's Express* held that respondent's rejection of the deduction of additions to a reserve for certain estimated expenses, to the extent they exceeded actual disbursements, was not a change in method of accounting. The critical distinction between *Schuster's Express* and the instant case is that the challenged deductions simply represented improper accruals. They did not carry over from year to year as does the inventory-type of accounting involved in the instant case. As stated by the Court in *Schuster's Express, Inc.*, at pages 596 and 597:

> The deductions claimed for insurance expenses in excess of actual expenditures do not appear to properly belong in any taxable period. Thus, we do not have before us a case involving the proper *time* for taking of a deduction. Under the regulations, a change in method of accounting does not include a change in the treatment of an item which does not involve the proper time for the inclusion of the item of income or the taking of a deduction. Sec. 1.446-1(e)(2)(ii)(b), Income Tax Regs.

The adjustments in the instant case do clearly involve the proper time for the taking of deductions since, under the analogy of inventory-type of accounting—absent the adjustments—income would eventually be increased when the overstated loss claims are finally liquidated.

Western Casualty & Surety Co., involved (so far as pertains to the section 481 issue) the respondent's rejection of the taxpayer's inclusion of unpaid commissions on deferred premiums in determining underwriting income. The Court sustained respondent's adjustment. In that case both parties had agreed that a change in the treatment of such unpaid commissions constitutes a change in treatment of a material item (not initiated by the taxpayer) requiring an adjustment under section 481. The

manner of computing such adjustment is reflected in the following excerpt from the Court's opinion (65 T. C. at 913):

> In making the adjustment required by section 481, respondent included in petitioner's 1967 income the entire accumulated reserve for unpaid commissions as of the close of 1966 ($6,527,381) less the amount applicable to pre-1954 years ($122,939), or $6,404,442. The parties dispute the propriety of respondent's adjustment under section 481 by which the entire accumulated reserve was included in petitioner's 1967 income. We are unpersuaded by petitioner's arguments, and we hold for respondent.

It is concluded that a section 481 adjustment should be made herein, patterned after the adjustment in *Western Casualty & Surety Co., supra.*[10]

In the instant case, by failing to adjust petitioner's 1958 yearend reserve for unpaid losses, respondent has effectively included in petitioner's 1959 income the entire amount of prior years' reserves to the extent that those reserves were similarly overstated. This is true because in determining the 1959 deduction for unpaid losses the 1958 yearend reserve is deducted from

10. The conclusion that a sec. 481 adjustment should be made is not in conflict with *Commissioner* v. *Standard Life & Accident Insurance Co.*, 433 U. S. 148 (1977, 40 AFTR 2d 77-5191, 77-2 USTC par. 9480). Although that case involved life insurance company accounting, the Supreme Court commented in n. 24:

> "Evidence of congressional respect of NAIC accounting methods is not limited to the portion of the Code concerning life insurance companies. In defining 'gross income' and 'expenses incurred' for purposes of taxing certain other insurance companies, Congress expressly requires computations to follow 'the annual statement approved by the National Convention of Insurance Commissioners.' 26 U. S. C. § 832(b)(1)(A),(b)(6)."

The Supreme Court's use of the term "accounting methods," as set forth above, was not in the context of sec. 481, and is not inconsistent with this Court's opinion in *Hanover Insurance Co., supra,* that although the NAIC form is to be followed, the actual figures are not likewise sanctified. *Standard Life & Accident Insurance Co.,* did not deal with the validity of the regulation (sec. 1.832-4(b)) upon which respondent here relies in justification of his method of testing petitioner's estimates of unpaid losses.

the sum of losses paid in 1959 and unpaid losses estimated at the end of 1959. But the Court must determine how much of the 1958 yearend overstatement was attributable to post-1953 years, since it is only to that extent that such prior accumulative overstatement may be taxed in 1959. The acounting method rejected by respondent, i.e., petitioner's failure to employ an adequate testing method in determining its total unpaid loss reserve, was a consistent method employed by petitioner. In making such computation it may therefore be fairly assumed that the 1958 yearend reserve for unpaid losses (claimed in the amount of $31,257,371) was overstated in the same proportion as respondent's 1959 reduction ($1,104,574) bears to the total 1959 yearend reserve claimed by petitioner ($30,390,690), i.e., 3.63 percent. Applying this percentage to the 1958 yearend reserve, produces an overstatement of unpaid loss reserve for 1958 of $1,134,642.

As above stated, the amount of overstatement of this same reserve must be determined as of the 1953 yearend. Petitioner's 1953 yearend unpaid loss reserve was $30,097,672. Applying the 3.63 percentage factor to determine the 1953 overstatement, produces an overstatement for that year in the amount of $1,092,545.

Under section 481 as it applies to years prior to the first taxable year in issue, respondent may tax in 1959 only the excess of the 1958 yearend overstatement over the 1953 yearend overstatement, i.e., $1,134,642 less $1,092,545 or $42,097. Accordingly, it is held that petitioner's 1958 yearend unpaid loss reserve, as adjusted, should be $31,257,371 (the reserve as reported) less $1,134,642 (the total overstatement of such reserve) plus $42,097 (the portion of such overstatement attributable to post-1953 years). This adjustment is in accord with the method of compliance with section 481 which was sustained by this Court in *Western Casualty & Surety Co., supra.*

In accordance with the foregoing, it is held that respondent is sustained in his adjustments for the years 1959, 1960, and the

period ending June 30, 1961, with the exception that a further adjustment should be made as to the year 1959 to conform to the holding hereinabove set forth under Issue II.

Decision will be entered under Rule 155.

APPENDIX D

UNITED STATES TAX COURT

HANOVER INSURANCE COMPANY, SUCCESSOR IN INTEREST TO: MASSACHUSETTS BONDING AND INSURANCE COMPANY,
Petitioner,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.
} Docket No. 1557-71

DECISION

Pursuant to the opinion of the Court filed November 22, 1977 and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

Ordered and Decided: That there is no deficiency in income tax due from, or overpayment due to, the petitioner for the taxable year 1959; and

That there is a defiicency in income tax due from the petitioner for the taxable year 1960 in the amount of $331,644.28.

(signed) Darrell D. Wiles
Judge.

Entered: Mar 30 1978

APPENDIX E

OPINION OF THE UNITED STATES TAX COURT DENYING PETITIONER'S MOTION FOR SUMMARY JUDGMENT

[65 T. C. 715]

UNITED STATES TAX COURT

HANOVER INSURANCE COMPANY, SUCCESSOR IN INTEREST TO: MASSACHUSETTS BONDING AND INSURANCE COMPANY, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 1557-71. Filed January 7, 1976.

Petitioner's predecessor, a casualty insurance company, reflected its income on its returns substantially on the basis of the underwriting exhibit of the annual statement approved by the National Association of Insurance Commissioners. Respondent adjusted the estimated figures for "unpaid losses" and "expenses unpaid," as shown on such returns and underwriting exhibit, under the "fair and reasonable estimate" test embodied in the predecessor to sec. 1.832-4(b), Income Tax Regs. Petitioner sought summary judgment on the grounds that sec. 832(b)(1), I. R. C. 1954, automatically precludes respondent's adjustments and that the regulation under which respondent acted in making the adjustments is invalid under that statute, under the Constitution, and under the McCarran-Ferguson Act. *Held,* the regulation is valid; and petitioner's motion for summary judgment will be denied.

Paul A. Teschner, for the petitioner.

Willard J. Frank and *Justin S. Holden,* for respondent.

OPINION

DAWSON, *Chief Judge:* This case was assigned to Special Trial Judge Lehman C. Aarons (pursuant to Rule 180 et seq. of the Tax Court Rules of Practice and Procedure) to conduct the trial thereof or otherwise proceed in accordance with said Rules. This Court agrees with and adopts his opinion, set forth below, on petitioner's Motion for Summary Judgment.[1]

OPINION OF THE SPECIAL TRIAL JUDGE

AARONS, *Special Trial Judge:* This case is presently before the Court on petitioner's Motion for Summary Judgment, filed September 8, 1975. Because of the importance of the legal question involved, the Court felt justified in entertaining petitioner's motion even though a delay in the trial was thereby entailed.

Petitioner is a casualty insurance company having its principal office in Massachusetts. The returns for the years involved were filed with the District Director, Boston, Mass. Such returns were for the calendar years 1959 and 1960 and for the period ending June 30, 1961, and were filed by Massachusetts Bonding & Insurance Co. (hereinbelow referred to as taxpayer). Taxpayer was merged into Hanover Insurance Co. (the petitioner herein) as of June 30, 1961.

Taxpayer was taxable under sections 831 and 832 of the Internal Revenue Code of 1954, as amended. Section 832 provides, in part:

---

1. Since this is a pretrial motion for summary judgment and since, solely for purposes of this motion, it has been assumed (as hereinbelow set forth) that there is no genuine issue of material fact, the Court has concluded that the posttrial procedures of Rule 182, Tax Court Rules of Practice and Procedure, are not applicable in these particular circumstances. This conclusion is based on the authority of the "otherwise provided" language of that rule.

(b) DEFINITIONS.—In the case of an insurance company subject to the tax imposed by section 831—

(1) GROSS INCOME.—The term "gross income" means the sum of—

(A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners * * *

Substantially the same provisions have existed in predecessor statutes since 1921.

Since 1944, the regulations (as now embodied in sec. 1.832-4(b), Income Tax Regs., and hereinbelow referred to as the challenged regulation) have provided substantially as follows:

(b) Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for "losses incurred" which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and the company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of such losses which, in the opinion of the district director are in excess of the actual liability determined as provided in the preceding sentence will be disallowed as a deduction. The district director may require any such insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for "losses incurred."

Acting under these regulations, the revenue agent, in auditing taxpayer's returns for the taxable years and period here involved determined that "losses incurred" had been overstated for each such year and for such period. In his amended answer, respondent additionally determined that "loss adjustment expense" had been understated on each of taxpayer's said returns. Other adjustments made on audit are not in issue.

For purposes of this motion for summary judgment it will be assumed that discrepancies between "losses incurred" and "loss expense incurred" as set forth in the annual statement on the one hand and the tax returns on the other hand do not raise issues of material fact. Although as shown by the affidavit filed by petitioner in support of its motion such discrepancies did exist, they did not in any case exceed approximately 1 percent of the respective amounts shown on the annual statement. Moreover, such affidavit indicates that "unpaid losses outstanding" and "unpaid loss expenses outstanding" (which appear to be the crucial disputed components in "losses incurred" and "loss expense incurred") were in identical amounts on taxpayer's annual statements and its tax returns. Solely for purposes of the Motion for Summary Judgment the correctness of this affidavit will be assumed.

In contrast, of course, the statutory notice of deficiency does raise issues of material fact, but petitioner maintains that under the statute and existing case law the annual statement is legally binding and conclusive upon respondent and that the challenged regulation (pursuant to which the respondent acted in making the disputed adjustments) is invalid under the Constitution and also under the McCarran-Ferguson Act (15 U. S. C. secs. 1011-1015) which confirmed to the States exclusive jurisdiction to regulate insurance companies.

At this point it should be noted that "losses incurred" and "expenses incurred" are (and have been for many years before the years here involved) also defined in the statute as elements or components of the term "underwriting income," which in turn is one of the terms used in defining "gross income" in section 832(b)(1), above quoted. See sec. 832(b)(3), (5), and (6). One of the elements in "losses incurred" is "unpaid losses" at the end of the year. Sec. 832(b)(5)(B). Similarly, one of the

elements of "expenses incurred" is "expenses unpaid" at the end of the year. Sec. 832(b)(6). The determination of "unpaid losses" and "expenses unpaid" involves the making of estimates and it is the reasonableness of such estimates which the respondent is challenging in this case. These terms are terms of insurance art and constitute annual statement terminology. See *Bituminous Casualty Corp.*, 57 T. C. 58, 80 (1971).

The history of sections 831 and 832, and the reasons prompting Congress to turn to the annual statement for the computation of insurance company income for Federal tax purposes, are set forth in *New Hampshire Fire Insurance Co.*, 2 T. C. 708 (1943), affd. 146 F. 2d 697 (1st Cir. 1945), and need not be repeated here. See also *Bituminous Casualty Corp., supra* at 79, 80, reviewing the development of the case law and observing that the Fourth Circuit (*United States* v. *Fidelity & Deposit Co.*, 177 F. 2d 805 (4th Cir. 1949)), agreed with the First Circuit (*New Hampshire Fire Insurance Co., supra*) that Congress intended to follow the annual statement form "precisely" in respect to the items specified (which include "losses incurred" and "expenses incurred"), whereas the Second Circuit (*Commissioner* v. *General Reinsurance Corp.*, 190 F. 2d 148 (2d Cir. 1951)) and the Ninth Circuit (*Pacific Employers Ins. Co.* v. *Commissioner*, 89 F. 2d 186 (9th Cir. 1937), and *Pacific Ins. Co.* v. *United States*, 188 F. 2d 571 (9th Cir. 1951)), held that the annual statement was intended to serve only as a guide and was not to be binding where inconsistent with the ordinary meaning of the terminology.

The primary rationale for adhering conclusively to the annual statement was the extreme complexity and technicality of insurance industry accounting and the search by Congress for an easy and simple taxing method. It is also to be noted, as petitioner points out, that in upholding the specialized type of accounting embodied in the annual statement, the courts have adopted a "long run" approach as an exception to the annual accounting principle (see *Security Flour Mills Co.*, 321 U. S.

281 (1944)). Indeed, in the First Circuit decision in *New Hampshire Fire Insurance Co., supra,* the court states in so many words that returns based on the convention form do not truly reflect income. But one of the counterbalancing considerations cited by that court was that "in the long run" it will not make any difference whichever method is used. Here too (although petitioner's briefs do not contain an analysis on this point) it may be that this could be true since an overstatement of "unpaid losses" and "expenses unpaid" at the end of the year might eventually be adjusted by the amount of losses and expenses actually paid in an ensuing year.

Aside from the fact that the First Circuit decision in *New Hampshire Fire Insurance Co., supra,* represents an affirmance of this Court's decision, the instant case is appealable to the First Circuit and we would feel bound by *New Hampshire Fire Insurance Co.*, if the issue of the validity of the challenged regulation (which was not in effect in the years there involved) were not inescapably involved in this motion. *Jack E. Golsen,* 54 T. C. 742 (1970). To apply *Golsen* to this motion would entail our speculating and concluding that the First Circuit's blessing of the convention form in *New Hampshire Fire Insurance Co.* was tantamount to a sanctification of the estimated figures as well as the form itself, no matter how unfair or unreasonable, and that the respondent's regulation of 31 years' vintage represents an invalid trespass into this hallowed area.

None of the cases cited above, nor any case cited to us, directly involved the validity of the challenged regulation. It appears that such validity was bolstered by this Court's opinion in *Bituminous Casualty Corp., supra,* in holding invalid the "all events" test embodied in Rev. Rul. 67-225, 1967-2 C. B. 238, as being contrary to the "legislative history" of the regulations with reference to the determination as to when a "liability" exists (see also Rev. Rul. 73-302, 1973-2 C. B. 220), and in finding that the reserves involved in that case "were computed in a reasonable manner." 57 T. C. at 58, 82. Moreover, the

cited cases which held the annual statement to be conclusive did not involve the reasonableness of the estimated figures appearing on such statement, but rather the format or methodology of such statement (e.g., whether or not reinsurance transactions with unadmitted companies should be taken into account (*New Hampshire Fire Insurance Co., supra*), or e.g., whether contrary to the then requirement of the annual statement form, the "case method" rather than the "formula method" could be used by the Internal Revenue Service where the former resulted in a lower unpaid loss figure (see *Columbia Casualty Co.*, a Memorandum Opinion of this Court dated May 13, 1948 (7 T. C. M. 282)).

In any event, we feel that we would be remiss in failing to apply to this case "the settled principle that 'Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law.' *Helvering* v. *Winmill*, 305 U. S. 79, 83; *Fribourg Nav. Co.* v. *Commissioner*, 383 U. S. 272, 283." *United States* v. *Correll*, 389 U. S. 299, 305 (1967). See also *Commissioner* v. *Noel Estate*, 380 U. S. 678 (1965).

In addition to the reason above set forth, we note the apparent fact that the affected industry, rather than contesting such validity at or about the time the challenged regulation was promulgated, adapted its practices to such regulation. The "apparent fact" referred to is not part of the record herein but has been called to the Court's attention by the excerpt quoted on page 23 of petitioner's reply brief from the Government's application for an extension of time within which to file petition for writ of certiorari in *United States* v. *Fidelity & Deposit Co. of Maryland*, 177 F. 2d 805 (4th Cir. 1949).

A portion of that application for extension of time, which follows directly after the portion quoted in petitioner's reply brief, reads:

> However, we are informed that there has been scheduled for the first week of April, 1950, a meeting of the Committee on Blanks of the National Association of Insurance Commissioners to which recommendations will be submitted by certain groups in the insurance industry to amend the convention form of annual statement to conform to the predominant tax treatment of certain items involved in these tax controversies. If the convention form of annual statement is satisfactorily revised to meet the Treasury Department's objections applicable to 1950 and future years, the Government would not wish to ask for certiorari in these cases. Hence, the extension herein is sought to protect the Government's interests pending the action of the Convention of Insurance Commissioners, and thus to avoid burdening this Court with a petition for certiorari that might not otherwise be filed.

(See Tye, "The Convention Form and Insurance Company Tax Problems," 6 Tax L. Rev. 245 (1951)). That article, in addition to quoting the above application for extension of time states that (effective in 1950) the "Convention Form" was amended by the National Association of Insurance Commissioners so that thereafter Schedule P incurred losses would be set forth in the underwriting exhibit purely on the basis of "case estimates." Such incurred losses had theretofore been reflected on the exhibit on a "formula" method if it produced a higher figure than the "case" method. After the 1950 change in the convention form any excess in incurred losses under the "formula" method was treated as a surplus adjustment on the statement rather than an income adjustment. The challenged regulation likewise requires the application of the "case" method.

While normally the attitude of an affected industry might not be relevant in the case of a challenge by one of its members as to the validity of a regulation, the situation here is a unique one. The statute itself prescribes that the affected industry's approved form (as approved by the State regulatory authorities) shall be the basis on which income is determined, and thus a change in such form effectively becomes a change in the applicable law.

Because of this unique interrelationship, the apparent adaptation of industry financial reporting to the concept of the challenged regulation would seem to lend additional support to the validity of the regulation.

Petitioner has additionally raised the question whether the challenged regulation is violative of the McCarran-Ferguson Act, 15 U. S. C. ses. 1011-1015 (Mar. 9, 1945), as an attempt to regulate the insurance industry in contravention of the following express congressional intent:

> No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance. 15 U. S. C. § 1012(b).

As can be gleaned from the legislative history of that Act (H. Rept. No. 143, 79th Cong., 1st Sess. (1945)) the business of insurance had traditionally been regarded as a local matter properly subject to and regulated by State laws. However, the Supreme Court in *United States* v. *South-Eastern Underwriters Association,* 322 U. S. 533 (1944), had held that the business of insurance was commerce and therefore subject to the Sherman Act. Subsequently, considerable uncertainty arose with respect to the constitutionality of State tax laws as well as other State regulatory provisions applicable to insurance companies. To alleviate this confusion the McCarran-Ferguson Act contained the provision as set forth in the above excerpt; and also suspended for a 3-year period the application to insurance companies of the Sherman, Clayton, and Federal Trade Commission Acts (except to the extent that the business of insurance was not regulated by State law). See *Securities & Exchange Commission* v. *Variable Annuity Life Insurance Co. of America,* 359 U. S. 65 (1959).

The application of Federal law to insurance companies, including Federal income tax (although it uses the annual statement as a basis for the tax), is not inconsistent with the intent of Congress to refrain from interfering with State regulation of insurance companies. Cf. *Board of Insurance* v. *Todd Shipyards Corp.,* 370 U. S. 451 (1962); *United States* v. *Sylvanus,* 192 F. 2d 96 (7th Cir. 1951), cert. denied 342 U. S. 943 (1952). Congress did not, under the McCarran-Ferguson Act, surrender to the States the power of the Federal Government to tax insurance companies and to issue regulations implementing the taxing statute. *Industrial Life Insurance Co.* v. *United States,* 344 F. Supp. 870 (D. S. C. 1972), affd. 481 F. 2d 609 (4th Cir. 1973), cert. denied 414 U. S. 1143 (1974). In the latter case, the taxpayer asked the court to invalidate Treasury regulation section 1.801-3(a) defining an "insurance company" for purposes of taxation under the Internal Revenue Code as contrary to the McCarran-Ferguson Act. The court declined to do so finding that the regulation reasonably implemented the power of Congress to tax insurance companies.

The crucial question in this regard is whether the regulation challenged in the instant case implements the statute in a reasonable manner, and does not take away an intended benefit. *The National Life & Accident Insurance Co.* v. *United States,* 524 F. 2d 559 (6th Cir. 1975). The intended benefit, as we understand petitioner's argument, is the right of the taxpayer to be "regulated" by the States (including, in particular, the right to follow State-imposed accounting requirements for all purposes including Federal income taxation).

In a sense all taxation is "regulation" in that it imposes sanctions if prescribed paths of conduct are not followed. But in the narrower sense it has consistently been held that accounting requirements of a regulatory authority (as in the case of savings and loan associations (*Bellefontaine Federal Savings & Loan Association,* 33 T. C. 808 (1960)); of railroads (*Old Colony R. R. Co.* v. *Commissioner,* 284 U. S. 552 (1932)); of power companies (*Gulf Power Co.,* 10 T. C. 852 (1948)); and of airlines (*National Airlines, Inc.,* 9 T. C. 159 (1947)), must yield to the requirements imposed under Treasury regulations. In other words, because a savings and loan association

must file one set of figures with the Home Loan Bank Board, another with the State regulatory authority, and a third with the Internal Revenue Service, the latter agency has not thereby usurped the regulatory authority of the first two. Much less, it seems to us, can a regulated taxpayer claim such usurpation, when all that the Treasury regulation attempts to do is to determine whether the figures representing estimates are fair and reasonable. What petitioner's argument would lead us to conclude is that McCarran-Ferguson Act would tie the Federal income tax to estimates which could be unfair and unreasonable because to question such estimates for Federal tax purposes would be tantamount to "regulation." We cannot so conclude and in our view the challenged regulation reasonably implements section 832 and does not take away any true benefit which the statute was intended to confer.

The brief answer to petitioner's argument that the challenged regulation intruded upon an area of regulation which belongs to the States is set forth in the following excerpt from *Penn Mutual Indemnity Co.*, 32 T. C. 653, 658 (1959), and the cases cited therein:

> Whether the business of the taxpayer can be subjected to Federal regulation has no bearing upon the validity of an exercise of taxing power with respect to that taxpayer. *Steward Machine Co.* v. *Davis*, 301 U. S. 548, 582; *Flint* v. *Stone Tracy Co.*, 220 U. S. 107, 152-158.

The "exercise of taxing power" necessarily encompasses the authority to issue needful regulations. Sec. 7805, I. R. C. 1954; *Brushaber* v. *Union Pacific Railroad Co.*, 240 U. S. 1 (1916). We find that a regulation which permits the respondent to disallow a deduction based upon an estimate which is unfair or unreasonable is indeed "needful."

In sum, we have carefully considered all of petitioner's contentions in support of its Motion for Summary Judgment and have determined that the motion must be denied.

An appropriate order will be entered.